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S. 1929, A BILL TO CREATE THE CORPORATION FOR SMALL BUSINESS INVESTMENT [COSBI]

HEARINGS

BEFORE THE

COMMITTEE ON SMALL BUSINESS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

ON

S. 1929

A BILL TO CREATE THE CORPORATION FOR SMALL BUSINESS INVESTMENT [COSBI]

FEBRUARY 24, 1988
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S. 1929, A BILL TO CREATE THE CORPORATION FOR SMALL BUSINESS INVESTMENT (COSBI)

WEDNESDAY, FEBRUARY 24, 1988

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to notice, at 2:12 p.m., in room SR-428A, Russell Senate Office Building, Hon. Dale Bumpers (Chairman of the Committee) presiding.

STATEMENT OF HON. DALE BUMPERS, A U.S. SENATOR FROM THE STATE OF ARKANSAS

The CHAIRMAN. The Committee will come to order.

In the interest of time, I am going to just insert my opening statement in the record and simply say that as everybody here knows, the witnesses and those in attendance who are interested in this legislation, this is a very comprehensive and fairly dramatic change in the way we finance Small Business Investment Companies [SBICs].

And I want to simply say that this bill when it comes out of this Committee—and in my opinion it will come out of this Committee—will be one that will be good for the taxpayers of the country, and it will be good for all the small business corporations who depend on this kind of funding for their existence and their future. I think there are a lot of things to recommend in this legislation, but I also want to alleviate some of the fears that some of you have expressed to me. I think many of the suggestions you have made have merit. I don't mean to say that I or the other Members of this Committee are going to agree with everything you have suggested in the way of changes, but, of course, we are going to take your concerns into consideration. We are going to take your testimony today and make notes of those concerns. And when we go to markup this bill, we'll remember those things and try to address them. Obviously, there are some things about the bill that do have to be changed.

And pursuant to that, of course, the House bill and the Senate bill will be at variance, and we'll have to go to conference on it. I'm not sure, however, that we're going to get any cooperation down at 1600 Pennsylvania Avenue. That just remains to be seen. We'll have to address that when the time comes.

We have a vote scheduled in the Senate I think just very shortly, we'll go as far as we can before the first vote.

If it is at all possible—you know, there is sort of a talent I think to summarize statements. When I was Governor, they used to say summarize, and even as a Governor who was used to speaking and summarizing everything, I had a tough time doing it. After I had worked so hard on my testimony, it was difficult to summarize. But let me plead with you to summarize, if you can, and I hope that you can. We'll have an expeditious hearing.

[The prepared statements of Senators Bumpers, Weicker, Dixon, Kerry, D'Amato, and Kasten follow:]

Statement of Senator Dale Bumpers
on S. 1929,
a bill to create the Corporation for Small Business Investment

Today the Senate Committee on Small Business begins hearings on S. 1929, a bill to create the Corporation for Small Business Investment, otherwise known as Cosbi. Joining me in sponsoring this bill is Senator Weicker, our distinguished ranking member, who has been closely involved with the Cosbi idea for several years. Other cosponsors are Senators Harkin, Boren, Rudman, Dixon and Kasten of this Committee, as well as Senators DeConcini and Bradley. I am very pleased with this initial showing of bipartisan support for Cosbi.

S. 1929 represents a new version of a not so new idea. The Small Business Investment Company (SBIC) and Minority Enterprise SBIC (MESBIC) industries have been working with the Senate and House Small Business Committees since 1984 to develop legislation that would privatize the Small Business Administration's SBIC program and enable the industry to manage itself and profit from the trading of its securities in the secondary market. Cosbi is the vehicle under which the industry can make this operational change, which it believes will add tremendously to its ability to provide long-term debt and equity financing to small businesses.

This new legislation is a great improvement over previous Cosbi proposals, and takes into consideration many of the objections voiced by SBA and other Administration officials in the past. For instance, S. 1929 includes a provision that would authorize the SBA to make such rules and regulations as necessary to insure that the purposes of the Act are accomplished. Moreover, a strict debt-equity ratio limitation was included in the bill to make it consistent with FNMA and other government-sponsored enterprises.

Despite this and other changes from earlier versions of the bill which offer a more thorough oversight of Cosbi by SBA and the Treasury Department, and which offer a substantial upside to the government in return for its implicit backing of Cosbi, SBA seems convinced that S. 1929 is virtually the same as previous Cosbi proposals and appears unwilling to work with this Committee to develop legislation that is acceptable to the Administration. Therefore, I hope the testimony of today's witnesses will show this Committee and the Administration that an earnest effort has been made to create sound legislation that will be a boon to the SBIC industry, the small business community, and the government as well.

This is, of course, not a perfect bill, and I am certainly willing to continue discussions about some items in S. 1929 with which the industry does not agree, particularly SBA's rulemaking authority. It is absolutely essential, however, to me as much as it is to the Administration, that any final bill provide for adequate public oversight of Cosbi. Additionally, the Committee may consider amending the bill to include authority for state and local governments to form SBIC's, an idea offered by Senator D'Amato which the industry would like to pursue.

I look forward to hearing from the SBIC and MESBIC industry representatives today, along with those that have worked for many months to help develop this legislation and the overall business plan for Cosbi. Their testimony will indicate why Cosbi is necessary, how it is expected to operate and the place it will hold in the credit marketplace.

We are planning to hold at least one more hearing on S. 1929, now scheduled for March 17, at which SBA and other Administration officials will testify. The industry will be given the opportunity to respond to their testimony. Other witnesses may also be asked to testify.

Before we begin, I would like to submit for the record a summary of S. 1929 and my floor statement on Cosbi from the Congressional Record, which explains the developmental background of Cosbi and offers a detailed explanation of S. 1929.

OPENING STATEMENT OF
SENATOR LOWELL WEICKER, JR.
ON S. 1929,
THE CORPORATION FOR SMALL BUSINESS INVESTMENT CHARTER ACT

MR. CHAIRMAN, I WANT TO COMMEND YOU FOR HOLDING THESE HEARINGS ON S. 1929, THE CORPORATION FOR SMALL BUSINESS INVESTMENT CHARTER ACT (COSBI), LEGISLATION THAT WE INTRODUCED LAST DECEMBER TO CREATE A PRIVATELY-OWNED GOVERNMENT CHARTERED CORPORATION TO FINANCE AND OPERATE THE SMALL BUSINESS INVESTMENT COMPANY (SBIC) AND MINORITY ENTERPRISE SMALL BUSINESS INVESTMENT COMPANY (MESBIC) PROGRAMS.

THE SBIC PROGRAM WAS FIRST AUTHORIZED IN 1958 TO PROVIDE SMALL EMERGING BUSINESSES WITH AN IMPORTANT SOURCE OF EQUITY AND LONG-TERM CAPITAL AND MANAGEMENT COUNSELING. IN 1972, CONGRESS ESTABLISHED THE MINORITY ENTERPRISE SMALL BUSINESS COMPANY PROGRAM TO CHANNEL INVESTMENT CAPITAL TO MINORITY-OWNED BUSINESSES. SINCE THEIR INCEPTION THE SBIC/MESBIC PROGRAMS HAVE INVESTED MORE THAN $7 BILLION OF VENTURE CAPITAL IN ABOUT 85,000 BUSINESSES. IT IS A TRACK RECORD OF WHICH THE INDUSTRY CAN BE PROUD.

SOME SAY THE SBIC PROGRAM WAS THE FORERUNNER TO THE VENTURE CAPITAL MARKET THAT EXISTS IN THIS COUNTRY TODAY. CURRENTLY, THE SBIC INDUSTRY ACCOUNTS FOR ABOUT 10 PERCENT OF THE VENTURE CAPITAL MARKETS. BUT, IT CONTINUES TO FILL AN IMPORTANT VOID IN THE VENTURE CAPITAL MARKETS NOT ADDRESSED BY TRADITIONAL VENTURE CAP-

ITAL COMPANIES. FOR EXAMPLE, SBIC'S CONCENTRATE THEIR INVESTMENTS ON FIRMS IN THE EARLY STAGES OF DEVELOPMENT. OVER SIXTY PERCENT OF SBIC/MESBIC FINANCINGS ARE DIRECTED TO SMALL BUSINESSES THAT ARE THREE YEARS OLD OR LESS. TRADITIONAL VENTURE CAPITAL FIRMS, ON THE OTHER HAND, TEND TO SEEK OUT FIRMS IN THEIR EXPANSION PHASE, USUALLY THEIR 4TH AND 6TH YEARS. FURTHERMORE, IN 1986 SBIC AND MESBIC FINANCINGS AVERAGED $178,000 AND $87,000 RESPECTIVELY. DURING THE SAME PERIOD, PRIVATE INDEPENDENT VENTURE FIRMS' AVERAGE INVESTMENT WAS $1.6 MILLION.

DESPITE THE PROVEN TRACK RECORD AND MARKET NICHE OF THE SBIC INDUSTRY, IN RECENT YEARS IT HAS FACED AN UNCERTAIN FUTURE. THREE YEARS AGO THE PROGRAM, ALONG WITH THE SBA, WAS TARGETED BY THE ADMINISTRATION FOR ELIMINATION. LAST YEAR, THE ADMINISTRATION PROPOSED INCREASED FEES AND REDUCTIONS IN THE GUARANTEES FOR THE PROGRAM, ALONG WITH THE ELIMINATION OF DIRECT FUNDING FOR THE MESBIC PROGRAM. AGAIN, THIS YEAR, THE PRESIDENT'S BUDGET PROPOSAL RECOMMENDS ELIMINATION OF DIRECT FUNDING FOR THE MESBIC PROGRAM. IN SHORT, THE ADMINISTRATION HAS MADE ITS PHILOSOPHICAL OPPOSITION TO THE PROGRAM ABUNDANTLY CLEAR. APPARENTLY, THAT OPPOSITION ALSO EXTENDS TO THIS LEGISLATION UNLESS ALL FEDERAL INVOLVEMENT WITH THE PROGRAM IS ABANDONED.

IN LIGHT OF FUNDING UNCERTAINTIES REFLECTED IN ADMINISTRATION BUDGET PROPOSALS COUPLED WITH AN UNSTABLE REGULATORY ENVIRONMENT, IT IS UNDERSTANDABLE THAT THE INDUSTRY FIRMLY BELIEVES ITS GROWTH AND EXISTENCE ARE THREATENED. THE LEGISLATION BEFORE THE COMMITTEE TODAY SEEKS TO REMOVE THAT UNCERTAINTY ABOUT THE PROGRAM'S FUTURE. THE ESSENTIAL PUBLIC/PRIVATE PARTNERSHIP IS

MAINTAINED WHILE ENCOURAGING GREATER PRIVATE SECTOR INVOLVEMENT AND REDUCING THE FEDERAL ROLE.

THE CONCEPT OF THIS LEGISLATION HAS BEEN BEFORE THE CONGRESS PREVIOUSLY. HOWEVER, I BELIEVE THIS PROPOSAL, WHICH HAS BEEN DEVELOPED WITH THE HOUSE AND SENATE COMMITTEES WORKING WITH THE INDUSTRY AND OTHERS, REPRESENTS A SIGNIFICANT IMPROVEMENT OVER EARLIER PROPOSALS.

FIRST, S. 1929 ADDRESSES MY CONCERNS THAT COSBI WOULD BE UNDERCAPITALIZED. IN ADDITION TO THE INITIAL $20 MILLION RAISED BY THE SALE OF CAPITAL STOCK TO SBICS AND MESBICS, THE GOVERNMENT WOULD PURCHASE $200 MILLION OF PREFERRED STOCK IN COSBI. THIS INFUSION OF CAPITAL WOULD MAKE COSBI FINANCIALLY SOUND. DIVIDENDS PAID ON THE PREFERRED STOCK ALONG WITH THE WARRANTS THAT COSBI WOULD ISSUE TO THE GOVERNMENT WOULD ALSO ALLOW THE GOVERNMENT TO SHARE IN ANY UP-SIDE OF COSBI OPERATIONS.

FURTHERMORE, SEVERAL OF THE OVERSIGHT AND REGULATORY ISSUES PREVIOUSLY RAISED BY THE ADMINISTRATION HAVE BEEN ADDRESSED. FOR EXAMPLE, COSBI WOULD HAVE A DEBT TO CAPITAL RATIO OF 15:1, THE TREASURY DEPARTMENT IS GIVEN EXPLICIT AUTHORITY TO APPROVE ALL OF COSBI'S SECURITY ISSUANCES AND THE GOVERNMENT WOULD BE GIVEN COMPLETE ACCESS TO ALL OF COSBI'S BOOKS AND RECORDS.

MR. CHAIRMAN, I LOOK FORWARD TO THE TESTIMONY THAT WE WILL RECEIVE FROM WITNESSES TODAY, AND I ALSO LOOK FORWARD TO WORKING WITH YOU TO MOVE THIS LEGISLATION FORWARD.

STATEMENT BY SENATOR ALAN J. DIXON
BEFORE THE SENATE SMALL BUSINESS COMMITTEE
FEBRUARY 24, 1988

THANK YOU, MR. CHAIRMAN. TODAY WE ARE ASSEMBLED TO HEAR TESTIMONY ON LEGISLATION TO CREATE THE CORPORATION FOR SMALL BUSINESS INVESTMENT, OR COSBI AS IT IS MORE COMMONLY KNOWN. THE PURPOSE OF COSBI IS TO TAKE OVER THE FUNCTIONS NOW BEING PERFORMED BY THE UNITED STATES GOVERNMENT WITH RESPECT TO FINANCING SMALL BUSINESS INVESTMENT COMPANIES.

THESE INVESTMENT COMPANIES (SBICs) SERVE TO FILL A SPECIAL NICHE IN THE VENTURE CAPITAL MARKET. NEWLY FORMED COMPANIES OR VERY SMALL COMPANIES IN NEED OF ADDITIONAL EQUITY CAPITAL OFTEN HAVE NO PLACE TO TURN FOR FUNDS. SBICs IN GENERAL, AND MESBICs IN THE CASE OF MINORITY COMPANIES, PROVIDE THESE BADLY NEEDED FUNDS. NO ONE DISPUTES THAT SMALL COMPANIES ARE VITAL TO THIS NATION'S ECONOMIC HEALTH. A RECENT ARTICLE IN BUSINESS WEEK WENT SO FAR AS TO SUGGEST THAT SMALL COMPANIES WILL PLAY THE KEY ROLE IN CLOSING OUR TRADE GAP. WE NEED TO BE SURE THAT THIS IMPORTANT SECTOR OF OUR ECONOMY HAS SUFFICIENT CAPITAL TO CONTINUE TO GROW.

THE FEDERAL GOVERNMENT CURRENTLY FUNCTIONS TO ASSURE SMALL BUSINESS ACCESS TO CAPITAL BY LICENSING, MONITORING, AND IN MANY CASES DIRECTLY FUNDING SBICs. DIRECT FUNDING COMES ABOUT WHEN THE SBA BUYS DEBENTURES ISSUED BY THE SBICs. UP UNTIL RECENTLY, THE SBA SOLD THESE DEBENTURES TO THE FEDERAL FINANCING BANK (FFB), GUARANTEEING PRINCIPAL AND INTEREST PAYMENT. THE FFB NOW HOLDS ABOUT $700 MILLION OF THESE DEBENTURES. COSBI WILL GET ITS START WITH THESE DEBENTURES, BUT WILL THEN GO ON TO REPLACE THE FEDERAL GOVERNMENT IN ITS ROLE OF PROVIDING SBIC ACCESS TO THE CAPITAL MARKET.

THE SBIC INDUSTRY HAS MATURED TO THE POINT WHERE THEY NO LONGER NEED DIRECT GOVERNMENT INTERVENTION. THEY HAVE PUSHED FOR AN ALTERNATIVE WHICH WILL REDUCE THE RESOURCES THE GOVERNMENT MUST COMMIT TO THIS IMPORTANT OBJECTIVE.

I LOOK FORWARD TO RECEIVING COMMENT FROM THIS AFTERNOON'S WITNESSES ON THE FORM AND SUBSTANCE OF COSBI. I TRUST THAT WE WILL BE ABLE TO EXPLORE THOSE AREAS OF QUESTION OR DISPUTE WHICH THE ADMINISTRATION MAY HAVE, AND COME TO A RESOLUTION. TIME AND AGAIN PRESIDENT REAGAN HAS EXPRESSED HIS DESIRE FOR PRIVATE ENTERPRISE TO TAKE OVER FUNCTIONS PERFORMED BY THE FEDERAL GOVERNMENT WHEN IT IS PRACTICABLE. I THINK COSBI CAN BE ONE OF THOSE SUCCESS STORIES.

STATEMENT OF SENATOR JOHN KERRY
ON THE PROPOSAL TO CREATE A
SMALL BUSINESS INVESTMENT CORPORATION

Thank you Mr. Chairman. The proposal before us today, to create an independent Corporation for Small Business Investment--COSBI--is an important and timely response to the growing demand for capital by small start-up companies. The almost loss of the capital gains preference in the 1986 tax reform effort means that new business formations in this country are jeopardized unless ensured other means to support risk-taking and capital formation.

Fortunately, we have such a means in the enormously successful Small Business Investment Company program, and the Minority Enterprise Small Business Investment program. Although the Reagan Administration has in the past opposed this program, the facts show that the SBIC program is well-conceived and well-implemented -- a model of public-private partnership -- and that it contributes many times its costs to the federal Treasury and the American economy in new jobs created, new products, new exports, and additional tax revenues. Companies like Apple Computer, Federal Express, Nike and Pandick Press all are examples of successful companies that needed SBIC financing to get off the ground.

If the program is so successful, one might ask, why change it at all? There is a sound reason for doing so in this case, and that is because the current budget environment calls for creative solutions that will allow continued program growth and operational stability without imposing additional drains on the US treasury.

By retaining the successful aspects of the SBIC program -- concerning the operation of the SBICs themselves and their relationship to the companies in which they invest -- while changing the nature of the financing to take the program off budget, we can acomplish our objectives.

STATEMENT BY SENATOR ALFONSE M. D'AMATO
BEFORE THE SENATE SMALL BUSINESS COMMITTEE
FEBRUARY 24, 1988

MR. CHAIRMAN, I WOULD LIKE TO THANK YOU FOR CALLING THESE HEARINGS ON LEGISLATION CREATING THE CORPORATION FOR SMALL BUSINESS INVESTMENT (COSBI). I WOULD ALSO LIKE TO WELCOME OUR DISTINGUISHED PANEL OF WITNESSES THIS AFTERNOON WHO WILL PRESENT THEIR VIEWS ON S. 1929.

S. 1929 CREATES A CORPORATION FOR SMALL BUSINESS INVESTMENT TO PROVIDE SMALL, EMERGING BUSINESSES WITH ACCESS TO A RELIABLE SOURCE OF VENTURE CAPITAL. MUCH OF THE GROWTH IN OUR RAPIDLY CHANGING ECONOMY HAS BEEN FUELED BY THESE SMALL, ENTREPRENEURIAL ENTERPRISES. IT IS OBVIOUSLY CRITICAL FOR THEIR, OUR ECONOMY'S, CONTINUED GROWTH THAT THEY HAVE REASONABLE ACCESS TO THE DEBT MARKET OR TO CAPITAL.

IRONICALLY BUT TYPICALLY, IT IS OFTEN THESE VERY FIRMS WITH THEIR PROMISE OF GROWTH AND DYNAMISM, WHICH HAVE THE MOST DIFFICULTY IN OBTAINING THE FINANCING MORE READILY AVAILABLE TO THEIR LARGER, MORE ESTABLISHED COMPETITORS.

MR. CHAIRMAN, I SUPPORT THIS BILL. I THINK THIS COUNTRY SHOULD INVEST IN ENTREPRENEURIAL CAPITALISM AND COMPETITIVENESS. THE REWARDS ARE TOO GREAT, AND TOO ESSENTIAL TO OUR WELL-BEING AND PROSPERITY.

AS OUTLINED IN THE BILL, COSBI IS CONCEIVED AS A PRIVATELY-OWNED, GOVERNMENT-CHARTERED CORPORATION, OPERATED FOR PROFIT, SIMILAR TO OTHER GOVERNMENT SPONSORED ENTERPRISES SUCH AS FANNIE MAE AND SALLIE MAE. THE OWNERS OF THIS NEW ENTERPRISE WOULD BE THE SBIC. SBIC WOULD INVEST $20 MILLION OF PRIVATE CAPITAL BY PURCHASING COMMON STOCK. IN ADDITION, THE GOVERNMENT WILL TAKE $200 MILLION IN PREFERRED STOCK. ONE OF THE MOST ATTRACTIVE ASPECTS OF THIS SET-UP IS THAT NO APPROPRIATION WOULD BE REQUIRED FOR THIS STOCK.

DURING THE COURSE OF THSES HEARINGS, WE NEED TO EXAMINE THE DIFFERENCE BETWEEN THE HOUSE AND SENATE VERSIONS WITH REGARD TO SBA AUTHORITY OVER COSBI. SHOULD SBA CONTINUE TO HAVE THIS AUTHORITY OR NOT?

I LOOK FORWARD TO THE TESTIMONY OF OUR WITNESSES THIS AFTERNOON AND TO THE INSIGHT THAT THEY ARE SURE TO PROVIDE THIS COMMITTEE ON COSBI LEGISLATION.

THANK YOU, MR. CHAIRMAN.

STATEMENT
U.S. SEN. ROBERT W. KASTEN, JR.
COMMITTEE ON SMALL BUSINESS
FEB. 23, 1988.

Good afternoon. I'm very pleased to be here today to endorse the Cosbi Charter Act.

Ever since the beginning of America's free-enterprise economy, small businesses with big ideas have been the main source of economic growth, social prosperity and broad-based increases in standards of living. If life is gradually going to improve for the people of any country, somebody will have to clear the brush and do the economic exploration for the others. These explorers are America's small businessmen.

Since it created the small business investment companies in 1958, Congress has considered the availability of long-term equity and debt financing to be one of the most important areas where the political process can help the small business community.

The Corporation for Small Business Investment (Cosbi) would oversee the whole SBIC process, raising capital and enhancing small-business access to capital markets. Cosbi will also provide subsidized financing for the minority enterprise SBICs, thus underlining the federal commitment to these programs while also avoiding unsustainable increases in federal expenditures.

The high-tech experience we've had in my home state of Wisconsin points to the real need for the kind of capital-formation assistance SBICs provide. Businessmen with a great contribution to make to a local economy -- businessmen like the brilliant scientist Steve Chen, who is starting a brand-new computer company named Supercomputer Systems, Inc., in Eau Claire, Wisconsin -- need capital ready and willing to be used to start small businesses.

Steve Chen has a dream that he can build a computer one hundred times faster than the ones currently made. But without a free flow of capital to small business, we'll never know if he and others like him can succeed. In that kind of a bargain, all of us end up losing -- in jobs, in productivity, and in overall standards of living.

In creating Cosbi, we in Congress are saying yes to seed money, to the essential first steps any business has to take in order eventually to make a substantial contribution to the life of the community. The Cosbi Charter Act is an innovative, far-sighted approach to one of our nation's top priorities.

The CHAIRMAN. Our first panel is Mr. David Jones, president of InterVen Partners of Los Angeles, representing the National Association of Small Business Investment Companies; and Mr. Divakar Kamath, vice president of Equico Capital Corp., New York, representing the National Association of Investment Companies. I will take you as you are listed here, Mr. Jones. If you will, please proceed.

STATEMENT OF DAVID B. JONES, PRESIDENT, INTERVEN PARTNERS, LOS ANGELES, CA, REPRESENTING THE NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. JONES. Thank you, Mr. Chairman, and other Members of the Committee. I am pleased to have the opportunity to testify today. I am David Jones, general partner and president of InterVen Partners in Los Angeles, CA. I am also chairman of the National Association of Small Business Investment Companies, the national trade association for the SBIC industry.

Our industry greatly appreciates your introduction of the landmark COSBI bill, S. 1929, and your scheduling of this important hearing. A special word of thanks is owed to the Committee staff. Their contribution has improved the COSBI legislation dramatically.

Mr. Chairman, I would ask that the written testimony I have submitted be included in the hearing record.

The CHAIRMAN. So ordered.

Mr. JONES. My written testimony covers in extensive detail a number of subjects that have been brought to this Committee's attention previously, and consequently I will use the limited time available to just address a few major issues.

Let me start with why COSBI is necessary. Mr. Chairman, despite its tremendously successful record, the SBIC Program has reached a critical crossroads. My written testimony enumerates a compounding and now an escalating series of problems with the Administration's management of this program that are incrementally destroying its essential fabric.

Thirty years ago, Congress designed the SBIC Program as a unique partnership undertaking with the private sector to fill a serious capital gap for small business, to provide long-term, high-risk equity and debt capital to small firms. This partnership performed well, expanded and provided tremendous results for over 20 years. In fact, the SBIC Program was a forerunner of today's robust venture capital industry.

Events of the past several years, however, make it clear that this partnership has come unraveled. SBA is no longer a partner in the process. It is now the adversary. SBA's vision is no longer risk-related; it is now risk-averse. SBA is now driven by a short-term transaction mentality. It has lost sight of the long-term nature of the program. SBA is no longer a responsive, flexible, can-do agency. It now has the reputation of a nonresponsive, obstructionist agency that doesn't understand market realities. I know that is a rather negative indictment of the agency's management of the SBIC Program, but I think it is a fair assessment.

In support of that view, I would like to submit for the record testimony from yesterday's House Small Business Committee hearing on COSBI. That testimony was presented by one current and three former SBIC executives. Each of their stories is an eye-opening, real-life example of what is wrong with SBA's management of the program. And if I may say so, I just wish that everybody could have been there to hear that testimony. It was heartfelt, sincere, unrehearsed and totally condemning. And when you review the Administration's composite actions over the past several years, whether it involves roadblocks in funding SBIC's, arbitrary regulatory actions or simply unresponsive, daily case-by-case dealings with individual SBIC's, a clear and negative pattern emerges.

Some in our industry claim these actions represent a not so subtle conspiracy to destroy the program, at first gradually, then bursting into the open in 1985 as a raw proposal to abolish the program, and now back to a process of piecemeal destruction. Others attribute these developments to sheer ineptness or incompetence.

Whatever the motivation, two results have become crystal clear. First, the industry is being seriously damaged, and its durability is being severely tested. We have lost 22 percent of the SBIC industry in the last 3 years. But even more important from a public policy perspective, uncounted tens of thousands of small businesses will be hurt as long as this negative trend continues.

The industry has concluded as prudent business people that it is absolutely essential to restructure the SBIC program and bring stability and predictability to our industry. We believe the time has come for bold action to assure that we can plan our future, protect our capital investments, and continue to serve small business. In short, we need a reliable partner for the long haul, and that partner is COSBI.

Let me turn to COSBI itself. I have submitted an executive summary for the record which describes the structure and operations of COSBI in detail. So, I will only touch on the highlights of the proposal. COSBI will operate as a capital bank for the SBIC industry, providing SBIC's access to a stable source of funds from the capital markets at reasonable costs. This assured source of affordable capital will increase the SBIC industry's capacity to make continued venture capital investments in small growth firms.

In addition, we believe the environment in which SBIC's operate their companies will materially improve under COSBI. The corporation will be directed by experienced professionals who have intimate knowledge of the industry. The operating rules of the road will be stabilized, communicated and well understood, and their application will become substantially more efficient. In short, SBIC's will have a reliable system they can depend on as long-term investors. At the same time, specific standards of good business conduct will be required and enforced. Abusive practices will be prohibited by statutory mandate, by Government oversight and by rules established by COSBI's board of directors.

But it is not just the industry that will benefit from COSBI. A number of important public policy purposes will also be served. Small business will be the big winner. COSBI will provide small business access to the major capital markets and in just a few years, we believe the flow of venture capital to small firms will increase by hundreds of millions of dollars.

We are also convinced that the increased rate of venture investments flowing through the new system will create hundreds of thousands of new jobs in a wide variety of industries, and thousands of product innovations and new commercial technologies. And if history is a good precedent, those new investments in the economy should generate millions of dollars in new tax revenues.

In addition, COSBI will produce reductions in Federal budget outlays over the years by eliminating Government guarantees of COSBI debentures and appropriations for the MESBIC Program. At current funding levels, over the next 10 years COSBI would save $390 million in direct appropriations and keep $2.3 billion in contingent liabilities off the Government's books.

The Federal budget will also benefit by the elimination of SBA's financial and regulatory apparatus and its accompanying payroll.

I'll now review very briefly the basic concepts of COSBI. COSBI will be privately owned and managed, a for-profit corporation. SBIC's will invest a minimum of $20 million of their private funds in voting common stock of the corporation. COSBI will be managed by a 15-member board of directors: 5 appointed by the President and confirmed by the Senate; 9 elected by stockholders; and 1 appointed by the MESBIC trust. The board of directors will set policy for the corporation. Day-to-day operations will be carried out by a professional staff hired by the board.

Chartered by an act of Congress, COSBI will have special attributes which give it status as a Federal agency. These special features are patterned after those of other Government-sponsored corporations, such as FNMA and SLMA. Agency status will permit COSBI to obtain funding in the capital markets at affordable prices, eliminating the need for the Federal Government to appropriate funds or issue Government guarantees. Once the corporation has been established, COSBI will provide a steady flow of funds to SBICs for reinvestment in small business.

Let me turn to several of the major financial items. COSBI will have what is referred to as a Treasury backstop. This feature was patterned after similar backstop provisions Congress granted to other federally-sponsored agencies. The purpose of the backstop is to help qualify COSBI securities as investment-grade agency investments. The investment banking community has advised us that the backstop is essential to COSBI's success. Without it, the sale of COSBI securities would be either virtually impossible or the pricing so extreme that COSBI's feasibility would be doubtful.

In theory a backstop is designed to provide financial support to an agency if it gets into serious financial difficulty. Backstops of existing agencies generally allow the Secretary of the Treasury, at his discretion, to step in to support the agency until it is restored to a sound financial position. Treasury doesn't like the backstop because it represents Federal support for COSBI no matter how contingent, and it does not meet their narrow test for "true privatization" of the program.

I would simply point out that the backstop is not a guarantee by the Federal Government. It is not a contingent liability of the Federal Government. It is not a guaranteed line of credit that can be drawn down automatically by COSBI. In fact, the backstop we have designed for COSBI is unique in that it is subject to the congressional appropriations process, and any discretionary use by the Secretary of the Treasury has been eliminated. Moreover, the backstop has been reduced to $500 million, an amount far smaller than that of any other Government-sponsored agency.

Another key financial feature of the bill involves COSBI's purchase of the outstanding SBIC debentures held by the Federal Financing Bank. COSBI's purchase of these debentures serves a very important program-related purpose. This transaction will give COSBI an initial asset base and immediate recognition in the capital markets, factors we believe are very important to the ultimate success of COSBI.

I am aware that proposed sales of Government assets have been heavily criticized as fire sales which create the appearance of short-term savings while losing significant long-term value. The COSBI legislation resolves this problem by providing for the purchase of these assets on a with-recourse basis at full market value.

Obviously, the decision to structure the FFB purchase with or without recourse is one to be made by Congress and not by the industry. Frankly, we are indifferent to which choice is made. We have explored the option of purchasing the portfolio on a nonrecourse basis, and would be willing to do so if Congress decided to change the structure of the sale.

I would point out, however, that a nonrecourse sale would result in a substantial discount in the market value of those assets, and a substantial decrease in the purchase price COSBI would pay.

The last financial item I want to cover is COSBI's borrowing authority. Last year's version of the bill had no restriction on COSBI's ability to issue debt. Treasury took exception arguing there should be a statutory borrowing limit. Our position had been that COSBI's board of experienced financial managers, COSBI's performance and conventional restraints of the capital markets would control COSBI's ability to borrow. And we still believe that is a responsible position.

However, since we are sympathetic to the underlying concept put forward by Treasury, we have modified the bill to accommodate their concern. The COSBI legislation now imposes, like the Fanny Mae statute, a 15 to 1 debt-to-capital restriction. The financial projections submitted to the committee show COSBI's debt-to-capital ratio for a 15 year period after start-up. Under those projections, COSBI's debt-to-capital ratio remains well within the statutory limitation.

Now, let me turn to the issue of regulatory structure.

The CHAIRMAN. David, I am going to have to interrupt you because I am going to have to run and vote at this point. I'll be back as quickly as I can get here.

Mr. JONES. Fine.

The CHAIRMAN. How much longer do you think you have to go on your testimony?

Mr. JONES. Two minutes.

The CHAIRMAN. Fine. I'll be right back.

[Recess.]

Senator **Weicker** [presiding]. Mr. Jones, I'm sorry for the interruption, but we're in the process of doing a little voting down there. And on behalf of the minority, let me welcome you. And why don't you go ahead and conclude your testimony?

Mr. **Jones**. Thank you, Senator Weicker. It is nice to see you again.

Gentlemen, I was about to address the issue of the regulatory structure of COSBI and to indicate that our industry has worked with the congressional staff to design an effective system of Government oversight to assure that the public policy objectives of the legislation are achieved. The industry has proposed a substantial regulatory and oversight structure for COSBI which we believe is more than sufficient to protect the Government's interest. Yet, it is not so intrusive that it would destroy the private market characteristics that make the program work.

Exhibit VI to my written testimony is a 5-page description of the numerous regulatory and oversight provisions in the COSBI legislation. As that exhibit shows, the regulatory framework proposed by the industry is comprehensive and exhaustive. I can assure you that it provides far more regulatory intervention than the industry would prefer.

The regulatory structure put forward by the industry includes a series of provisions to ensure that SBICs operate within the letter and spirit of the regulation. The major rules which currently govern SBIC operations are specifically codified in the statute. The regulations COSBI issues to implement those major rules must be approved by a majority of the public directors of the corporation. The statute gives COSBI substantial enforcement powers, including termination of an SBIC's license, assessment of penalties and removal of officers or directors of SBIC's. SBIC's are required to meet licensing standards set by the statute and by the corporation. COSBI will have statutory authority to regulate SBIC's by contract, and that arrangement will place appropriate restrictions on SBIC business practices and prevent SBIC's from engaging in certain prohibited activities.

I might add that we contemplate that those regulations will mirror very closely the current set of regulations currently imposed by the SBA.

COSBI will also ensure that SBIC's are in compliance with the rules and regulations through annual financial audits and biannual compliance audits by independent CPAs and by COSBI auditors. Extensive Government oversight and audit powers are overlaid on top of that process to assure that COSBI is carrying out its responsibilities and the public policy objectives of the statute are met.

A key feature is SBA's oversight power which includes unlimited access to all of COSBI's books and records and unlimited authority to review any aspect of COSBI's financial or regulatory performance. Beyond that is an extensive series of regulatory and financial audits and reports on COSBI's operations that is too long to list.

S. 1929 also contains a new substantive regulatory provision that was not in prior versions of the bill, one that authorizes the SBA Inspector General in certain circumstances to audit individual SBIC's. We urge that the Committee modify this provision by adopting the language of the House bill which provides that the Inspector General has authority to audit only those individual SBIC's that have outstanding debentures guaranteed by the SBA. The singular reason for giving the Inspector General this type of audit authority is to protect the Government's specific financial exposure with that SBIC. If an individual SBIC has no debentures guaranteed by the Federal Government, there is no financial interest that the Government has to protect. Under those circumstances, it is our opinion that the audit responsibility for individual SBIC's should reside with COSBI.

We are convinced that the industry's proposal for oversight and regulation is exhaustive and the correct approach. We believe the industry's proposal is more than sufficient to protect the Government's interest. Yet, it is not so intrusive that it would destroy the private market characteristics that make the program work, which brings me to my final point on regulations.

Senator Weicker, there is one key provision in the Senate bill which the industry would find it very difficult and, indeed, virtually impossible to accept. This is the provision giving SBA rulemaking authority over COSBI. Based on past experience and countless difficulties with SBA, giving the agency such authority is in our opinion creating a disaster waiting to happen.

Giving SBA rulemaking authority would simply mean a continuation of the battle to ward off arbitrary and intrusive attempts by the agency to disable the program. If SBA rulemaking authority is retained in the COSBI legislation, it will represent a major disincentive to SBIC's to participate in COSBI's formation and capitalization. In my opinion COSBI will never be organized or made operational if SBA retains rulemaking authority over the process.

On the other hand, we are absolutely convinced that the oversight and regulatory framework we have proposed for COSBI will be highly effective and will ensure that the public policy objectives of the legislation are carried out. Our proposal couples the knowledge and awareness of professional SBIC executives with an absolutely compelling financial self-interest to keep the industry free from abusive practices. This mix of risks and awards creates an overwhelming incentive for consistent and diligent oversight and strong enforcement of proper business activities.

In short, we strongly urge the committee to strike the SBA rulemaking authority from S. 1929 and substitute in its place the SBA oversight provisions contained in the House version of the COSBI legislation.

Members of the Committee, let me conclude by saying that we believe COSBI represents a bold historic step for our industry. Over the past 30 years, SBIC's and MESBIC's have built an impressive record of developing the Nation's most job-generating and innovative small businesses. The industry is now at a critical crossroads that will determine its future. Under COSBI, SBIC's and MESBIC's will assume the risk of operating in the private marketplace in return for the chance to eliminate the chronic problems which limit our effectiveness. Both NASBIC and NAIC and our member companies are convinced that if COSBI becomes a reality, everyone, small business, the Government and the industry, will be a winner.

Members of the Committee, this concludes my statement. I would be pleased to respond to any questions.

[The prepared statement of Mr. Jones follows:]

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February 24, 1988

STATEMENT OF
David B. Jones

before the

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

Good afternoon! It is indeed a pleasure to be here today, and to have the opportunity to testify before this Committee.

I am David Jones, General Partner and President of InterVen Partners, which is located in Los Angeles, California. I also have the distinct privilege of serving this year as Chairman of the National Association of Small Business Investment Companies (NASBIC), which represents the overwhelming majority of all licensed Small Business Investment Companies (SBICs).

INTRODUCTORY COMMENTS

Mr. Chairman, let me just say at the outset that the SBIC industry greatly appreciates your introduction of S. 1929, the proposed legislation to create the Corporation for Small Business Investment (COSBI). We also appreciate your expeditious scheduling of this important hearing on the COSBI proposal and the opportunity you have given us to testify on this landmark legislation which is so vital to the future and well-being of the SBIC industry.

I would also like to make it clear that the COSBI proposal has been developed through a joint-venture between the SBIC and the Minority Enterprise Small Business Investment Company (MESBIC) industry. This effort has been a true partnership between the National Association of Investment Companies (NAIC) and NASBIC, in terms of effort, creativity, time and resources devoted to the development of COSBI. Both organizations fully support this legislation and we pledge to do everything in our power to help you enact this bill into law!

A special word of thanks is owed to your very able staff, John Ball and Patty Barker, and to Bob Dotchin and Bob Wilson of the Minority staff, who have worked so hard to refine and craft this improved COSBI bill over the version introduced last Congress. We appreciate their able advice, their very positive and cooperative attitude and their time and diligence in helping to perfect this legislation.

Mr. Chairman, my testimony today will concentrate on three primary areas: (1) the importance of SBIC financing to small business; (2) why we believe enactment of COSBI is necessary if the SBIC industry is to continue to meet the challenges of helping emerging growth companies at critical stages of their development; and (3) the basic structure of COSBI, what it will accomplish, and how it will operate. My discussion of COSBI will also address the specific issues you raised in your letter of invitation to testify. Mr. Kamath will cover several of these points from the special perspective of the MESBIC industry, and will discuss the special interrelationship of COSBI and the MESBIC Trust.

IMPORTANCE OF SBIC FINANCING TO SMALL BUSINESS

Mr. Chairman, the SBIC industry is extremely proud of its track record in financing small growth firms, and we believe that record is unmatched by any other government-sponsored program. For more than 28 years, our industry has been a major source of venture capital for small business. During this period, SBICs and MESBICs have invested nearly $7 billion in over 85,000 small growth firms. Today, over 450 SBICs and MESBICs, with total assets in excess of $3.2 billion, are actively engaged in the financing of thousands of small, job-creating growth companies. The graph attached to my testimony as Exhibit I shows the investment activity of the SBIC and MESBIC programs throughout the lives of the programs -- which you'll note maintained a strong upward climb even during the recent struggle in 1985 and 1986 to save the programs from the Administration's budget ax.

Mr. Chairman, SBIC-financed small businesses have been at the forefront of that leadership in creating new products, new technologies, new innovations and new jobs. Studies of the impact of the SBIC program prove that SBIC investments -- and the small firms financed through the program -- proportionally produce positive economic benefits for America's economy far greater than that of any other sector of the small business community.

One of the significant findings of an economic impact study of the SBIC program performed by the international accounting firm of Deloitte, Haskins & Sells was that SBIC-financed small firms had a growth rate 10 times greater than those of other small companies in sales, profits and employment. In addition, SBIC-financed companies produced new Federal tax revenues at a rate 5 times greater than those of other small businesses. Clearly then, the performance of the SBIC industry and its managers has meant incredible growth and success for the small firms in which they invest.

Another important conclusion of the Deloitte study was that a new, permanent job is created for each one-time SBIC investment of $6,500. The SBIC industry is currently investing funds in emerging growth companies at the record annual rate of $475 million. Based on the Deloitte analysis, this means that the industry's investments are now creating over 73,000 new jobs a year. It also means that over the life of the program, SBICs and MESBICs, with investments of over $7 billion in small business, have created over one million new jobs. Think of it -- that is an incredible record of accomplishment for any program.

This success has come at absolutely no real cost to the Federal Government, as demonstrated by another striking conclusion of the Deloitte study that the Federal Government spent only $312 in direct government outlays to create a new job through the SBIC program. When you take into account the fees levied on SBICs to offset program costs, the direct cost to the government is even less. When tax revenues generated by the program are considered, the Federal Government comes out a major winner in terms of tax income, as well as in creating new employment.

Let me also point out that a follow-up study prepared by Deloitte showed that in return for the government's annual outlay of $4 million to run the SBIC program, the Federal Government received $440 million in increased tax revenues from SBICs, the companies they invested in, and their employees -- a remarkable ratio of benefits to costs of 110 to 1.

Mr. Chairman, in preparation for hearings held by this Committee two years ago, SBA prepared a chart documenting the success of 10 outstanding businesses which received venture capital from one or more SBICs. It showed that these companies paid almost $199 million in Federal corporate taxes in just one year alone, 1983. This is truly amazing when you consider that only 10 of the small businesses we assisted at start-up or at a crucial stage of their development paid more in taxes in one year than the entire industry drew down in loans that same year. Obviously, these 10 represent some of our most dramatic "winners", but I can assure you that there are thousands of other portfolio companies which are major taxpayers today only because they received dollars and management counsel from an SBIC.

Clearly, as demonstrated by these studies, SBICs and their portfolio companies return to the Federal Treasury in increased tax revenues far more than the handful of dollars expended by the government.

Another significant benefit is seen in the substantial private capital the SBIC program generates for investment in small business. During the past eight years, for example, for every dollar the government has made available for investment in small business, SBICs invested almost two of their own private dollars in our nation's emerging growth firms. I would say that that record alone proves that the Federal Government, in its effort to assist small business, gets substantial leverage and help from the SBIC industry.

Mr. Chairman, the tens of thousands of small businesses we have supported at time of formation, at a critical stage of expansion or development, or during a crisis when the survival of the business was at stake, are the progeny of the SBIC industry. The roster of SBIC-backed companies is an honor roll exemplifying dynamic capitalism at its best. Cray Research, National Car Rental, Intel, Federal Express, Apple Computer, Pandick Press, Teledyne, Berkey Photo, Memorex, Midway Airlines, Amdahl, NBI, Digital Switch, Dataproducts, Atlantic Research -- those are just a few of the better known firms. Their products and services have spurred productivity and innovation, increased competition, expanded export markets, and created permanent new jobs.

But it's not just the glamorous "high-tech" investments we finance. There are tens of thousands of other small firms financed by SBICs throughout the country that you may not read about in the Wall Street Journal, but which add jobs, value and economic prosperity to their local communities.

For example, I have personally participated as an SBIC manager in the financing of a food packaging firm which grew from zero to $15 million in sales in 2 years; a valve and guage company which grew from under $1 million to over $15 million in 7 years; and a startup retailer which grew to over $150 million in sales in under 3 years. Each of these firms became profitable (and thus, a taxpayer) early in its life, and each created well over 200 jobs.

Mr. Chairman, attached to my testimony as Exhibit II is a list of small firms which are representative of small companies financed by the industry, with a brief synopsis of what SBIC financing has meant to the growth and success of those companies. This list was compiled last year as part of NASBIC's outreach to its membership to identify companies that might be chosen as deserving of recognition at our regional and annual meetings.

I should also point out that SBICs are not duplicating any private sector activity. Entrepreneurs come to us because they can't get the capital and the management assistance elsewhere. They can't get bank loans; they can't raise money through a public offering; they have exhausted their own personal resources and probably the dollars of their families and friends. America's support for its entrepreneurs and its venture capital industry are envied throughout the world and the SBIC industry is a crucial part of that picture. Few of the 85,000 firms the SBIC industry has helped would have been born, would have grown, or would have created jobs if the SBIC program had not been established. Major corporations can go on borrowing from institutional lenders and raise capital through public offerings, but there's generally no room in that scenario for the entrepreneur. When they receive SBIC financing, our portfolio companies don't have AAA credit ratings; they can't go public. Their ideas for new products and services are often ridiculed by the established "experts" in the field. No public employee would have dared to finance or give a contract to Cray Research when it began in 1972. Today, Cray Research is the international leader in the manufacturing of super-computers. Indeed, IBM and Control Data shunned the super-computer field when Cray Research set out to become the pioneer of that industry. Only an SBIC was willing to back Mr. Cray -- as we know from testimony presented to this very Committee -- and the rest is history.

Mr. Chairman, I'm sure you're also aware of the 1984 study prepared for the Joint Economic Committee of the U.S. Congress entitled Venture Capital and Innovation, (Joint Economic Committee Print, 98th Congress, 2d Session, S. Prt. 98-288), which examined the impact of venture capital on the American economy. It concluded that venture capital had become "indispensable to the nation's overall climate for entrepreneurship and innovation" and noted that because the venture capital community has a strong preference for funding young, innovative companies that offer significant potential to improve productivity, it is a "vital link in the process of capital formation, technological change and growth for the Nation."

As important, the Joint Economic Committee study examined the role of SBICs in the venture capital process and concluded that "SBIC investors definitely broaden the reach of the venture capital community by extending financings to firms and industries that are outside the investment scope of independent and corporate fund managers." The study reached the conclusion that "(T)his finding is important because it shows that SBICs are satisfying a capital market need that is not currently being met if SBICs did not exist."

Mr. Chairman, when you compare the size of financings, age and stage of financing, types of small businesses financed and the geographical dispersion of financings of SBICs with those made by independent venture funds, the evidence is irrefutable that SBICs provide a source of venture financing for small firms which is not only essential -- but simply not available elsewhere.

Statistics compiled by SBA on the average size of SBIC financing, when compared to data on financings of private independent venture capital funds, show that, while the average SBIC financing to a small firm is about $269,000, the average size financing of independent venture fund is closer to $2 million. Needless to say, these are two entirely separate market niches. Although there may be some minimal overlapping of the edges of the two industries, clearly they provide financing to firms at opposite ends of the financial need spectrum. This is reflected in the graph attached to my testimony as Exhibit III.

Furthermore, SBICs annually provide financial assistance to small firms in every region of the country. And this wide dispersion of SBIC financing should come as no surprise since there are SBIC licensees in nearly every state, and the size of the deals they look at are more likely to take them to more sections of the country -- rather than primarily to locations such as California's Silicon Valley or Boston's Route 128 corridor. Exhibit IV, which shows the geographical dispersion of SBIC investments throughout the United States from 1980 through 1986 totalling nearly $2.7 billion, clearly demonstrates that SBICs have a wide geographical range of investment activity, with investments in small business in every state.

In addition, although independent venture funds devote a substantial 39% of their financings to firms less than 3 years old, in 1986 the SBIC industry allocated over 64% of its funds to firms 3 years old or less; and MESBICs invested 67% of their funds to fledgling firms less than 3 years old. This is graphically shown in Exhibit V.

I hasten to add, Mr. Chairman, that these comments are not in any way intended to diminish or detract from the importance of the non-SBIC venture capital funds. It is well-documented and indisputable that independent venture funds make available financing that is absolutely essential and critical to the health and well-being of our nation. Clearly there is absolutely no substitute for the assistance they provide. But it is also equally clear that the activities of private independent venture funds are not designed to adequately serve all the equity financing needs of small business, nor do they duplicate the role played by the SBIC industry.

Most SBICs invest in small business deals that are not feasible for independent venture capital firms. By using leverage, SBICs can make an acceptable return on their invested capital by providing funding to entrepreneurs in traditional industries. For that reason, SBICs are able to assist a much wider range of businesses than firms in other segments of the venture capital industry. And any dissipation of the more than $2 billion committed to SBICs would be an enormous blow to the small businesses of this country.

Mr. Chairman, the SBIC program has been successful because it is based on the time-tested business principles which drive America's free enterprise system -- private capital at risk, profit motive, market discipline and the bottom line reality of a risk/reward relationship. This has made it a "win-win" program for the small business and the Federal Government, which, through the SBIC program, generates millions of private dollars to be invested annually in small business.

WHY COSBI IS NECESSARY

Despite this successful record, however, the SBIC program has reached a critical crossroads. Let me explain why by giving a brief review of the industry's history in the areas of access to leverage, government regulation and growth of the industry.

1. Instability of Funding

A review of the Federal Government's track record in making available funding for the SBIC and MESBIC programs provides a clear reflection of how unstable the Federal Government has been as a source of funds for the industry.

From 1959 until 1971 government leverage for the program was available only through direct, on-budget financing which required a year-by-year appropriation of funds by the Congress. In six of those twelve years, the SBIC industry received no funding at all, either because Congress failed to appropriate funds or because the Administration failed to release the dollars.

In the period from 1971 through 1974 a process was established through which SBIC debentures guaranteed by SBA were sold in blocks through Wall Street investment banking houses. While this approach provided some funds for the industry, the way it was structured was too cumbersome and costly to work effectively or on a timely basis.

Then in 1974 yet another change came about when the system of placing SBA guaranteed debentures with the Federal Financing Bank (FFB) was put into place. This system worked effectively for a period of some six years when Congressionally authorized SBIC guarantee levels were adequate to meet the industry's level of demand for funds.

Beginning in 1981, however, the serious shortcomings of this system became evident -- impacted by conscious restrictions on the growth of the Federal Budget, rapid expansion of the industry and the need to "roll over" previously outstanding SBIC debentures which had reached maturity. The industry's need for funds far exceeded the authorized levels of leverage; and SBA was forced to allocate the limited funds that were available, to place artificial ceilings on the amount that any one SBIC could borrow, and on occasion to close the loan "window" completely. At one point during this period, the appropriations for the MESBIC program were completely cut off.

Then in 1985, the Administration submitted a budget proposal seeking not only elimination of funding, but termination of the SBIC and MESBIC programs entirely! This was the ultimate irony of the success of the SBIC program, which despite funding problems had continued to provide financing to small business at record levels.

Clearly, the Administration's proposal was made not based on any measured evaluation of the SBIC program. Indeed, just a few months earlier President Reagan had applauded the significant contributions of the SBIC program to the nation as a whole and to small business in particular. In a televised tribute to the industry at its 25th anniversary celebration, the President recognized that "SBICs and MESBICs have been pioneers of private sector/government efforts to expand the availability of venture capital for small business" and that the industry had "proven that public/private partnership can do things that government alone cannot accomplish."

Yet despite the recognized accomplishments of the SBIC industry, it was caught up in a political battle - waged not on the basis of the industry's track record, but on ideology - which threatened its very existence. Only through the leadership of this Committee and House Small Business Committee -- and a refusal to forfeit the substantial and sustained benefits of the program to the national economy and small business -- was the SBIC program saved.

Finally in the spring of 1986, in order to achieve mandated budget savings agreed to by Congress and the Administration as a compromise to save SBA, the current funding system of selling in the public market securities based on a pool of SBA-guaranteed SBIC debentures was enacted. Yet despite this law, it became very clear that the then-Acting SBA Administrator did not intend to implement the new funding system authorized by the Budget Reconciliation Act.

As a result of those events the lending window for SBICs was completely shut down again -- this time for nearly six months. It was only in reponse to Congressional hearings and the efforts of the Small Business Committees of the Senate and the House that he reluctantly agreed to comply with the law and put the new system in operation.

Today the new funding system is in place and it is working; but it is more costly, still subject to the control of government officials who do not truly understand the needs of the SBIC industry and far from a perfect system. And although the Administration has withdrawn its proposal to terminate the SBIC program, the industry is still reverberating from the Administration's nearly fatal proposal, and the program is still subject to additional Gramm-Rudman-Hollings cutbacks and budget freezes.

But even after being "saved", there were, as we've come to expect, more surprises for the industry. In its budget submission for the current fiscal year the Administration indicated it would be recommending legislation that would reduce the government's guarantee of SBIC debentures from 100% to 90% -- a proposal that would have a devastating impact on the SBIC industry if adopted. Although offered as part of the the Administration's policy of "risk sharing", it fails to recognize that the structure of the SBIC program already puts SBIC investors 100% at risk before the government loses one thin dime. Put another way, each SBIC bears 100% of each loss it sustains and SBA loses only after the entire capital of the SBIC is wiped out. The idea of applying a "risk sharing" 90% guarantee concept to a program where the private sector already stands to lose all of its capital and assets before the government's position is even 1% at risk makes no sense at all. Yet, we understand that such a proposal is still under consideration at OMB.

One investment banker has advised that he would be unable to sell such a hybrid security. Another has said that such a security might be salable, but because of its unusual characteristics, it could only be sold at extremely high pricing scenarios. Under either scenario -- one resulting in SBICs being unable to obtain leverage funds at all through the program, and the other making the cost of financing so high as to make it prohibitively expensive -- the result would be the same: the inability of SBICs to obtain leverage, the erosion of capital for small growth firms, and the eventual demise of the SBIC industry.

Although it would take legislation to enact such a proposal, it is difficult for the industry to survive -- let alone fulfill its long-term commitment to small business -- when confronted with the spectre that such arbitrary and unwarranted funding proposals with such a devastating impact on the industry are even being considered.

As part of this never-ending attempt to undermine the solvency of the SBIC program, the Administration, in the budget proposal for fiscal year 1989 submitted to Congress just last week, recommended over a 35% cut in the SBIC program authorization level -- from $233 million to $150 million; and it proposed to eliminate direct funding for the MESBIC program altogether!

I'm sure that SBA will claim that this $83 million program reduction is warranted because SBICs didn't use their full appropriations for the last fiscal year. But this rationale fails to recognize the newness of the new funding system and the time it took to get the system fully operational; the change in the tax code which may have given a number of SBICs temporary liquidity; the sometimes cyclical nature of the needs of the venture capital industry for additional capital; and the fact that SBA in its review of applications for funding usually "washes out" a substantial number of applications for leverage. Based upon this latest budget submission, I would certainly question the basis on which a number of these applications may have been denied. I suppose if you deny enough requests for leverage, it becomes a self-fulfilling prophecy that the program won't utilize its full funding authority.

And what about the MESBIC program -- how can the Administration once again attempt to cut the legs out from under that industry by proposing to undermine the MESBICs funding system? Isn't this just one more veiled attempt to kill the program altogether? I'm sure Mr. Kamath will also have something to say about this proposal.

2. Uncertain Regulatory Environment

Regulation of the SBIC program is inherently a complex and delicate process since it involves intervention in a fast-moving investment activity dealing with private market transactions. SBIC managers are faced with hundreds of judgemental decisions which can translate into the success or failure of the small firms they finance, and millions of dollars gained or lost for their investors.

It is essential that SBIC managers to be able to rely with a substantial degree of certainty on the long-term continuity of government policies. When that certainty disappears and the government becomes an unreliable partner, the program and the benefits it provides to small business begin to unravel.

During the 1980's this "unraveling" has taken place much too frequently to the substantial detriment of the industry. SBA's policies have created a series of crises harmful to the industry, with ramifications almost as serious and deadly as the industry's inability to rely on a stable funding source. These proposed regulations appear to have been generated by SBA's genuine lack of understanding of marketplace realities, and a desire to over-regulate where regulation is neither necessary nor appropriate.

The result has been that the temper of the industry's steel has been tested as never before. For example, a few years ago SBA proposed a complete overhaul of the SBIC regulations, which, if adopted in their original version, would have devastated the industry: a mandatory equity proposal requiring every SBIC to have investments in straight equity as a percentage of their portfolio; operating agreements for equity-oriented SBICs before they could get leverage, if they could get it at all; and a forced investment diversification proposal by SIC code, just to name a few. Most of these policies were initiated without any discussion with the industry, and without any clear understanding or consideration of the operating implications.

More recently, in the Administration's budget submission for the current fiscal year, it proposed to add an additional 1% users fee to the cost of the 1.185% users fee -- even though the current users fee already pays for all of SBA's current costs to operate the SBIC program! On top of that, some of the documentation we've seen on this proposal would suggest that the proceeds received from this new "users fee" couldn't even be used for its intended purposes, that is, to pay for the services used -- clearly, a "catch-22" patently absurd proposal.

Quite separate from this users fee proposal, SBA also proposed that it intended to increase by 60% the audit/examination fees of SBIC -- even though it had just doubled these examination fees as recently as four years earlier.

Unlike the 90% guarantee proposal which would require legislation to implement, SBA could undoubtedly implement these fee proposals through its regulatory powers. And it would probably have done so, Mr. Chairman, were it not for your efforts in placing legislative language in the Continuing Budget Resolution which precludes SBA from implementing these proposals.

But again, these are just a few of the never-ending, unwarranted regulatory initiatives that threaten to seriously undermine the effectiveness of the SBIC program, and more importantly, the ability of SBICs to provide affordable long-term financing to small business.

I would suggest, Mr. Chairman, that when Congress is forced to take legislative action -- almost on a continual basis -- to prevent SBA from adopting regulations that seriously undermine, rather than assist, programs under its jurisdiction, something is seriously wrong and corrective action must be taken.

3. Growth of the Industry

Clearly, these funding and regulatory policy problems have been detrimental to the SBIC industry's ability to grow and provide critical financing to small business. And if these policies continue, they could easily sound the death knell for the SBIC industry.

Look at what was happening to the SBIC industry prior to the Administration's proposal to terminate the SBIC program. Even with funding and regulatory problems, the industry had been expanding at a rapid pace with an average of over 40 new licensees per year coming into the program from 1978 through 1984; in addition, because of the success of the program, relatively few licensees were leaving the program.

In 1985 however - the first year the Administration put the SBIC program on the chopping block, licensees, threatened with termination of their business, increasingly began to leave the program and look for other things in which to invest their time and resources. In addition, the number of new licensees in the program began to decrease dramatically -- with only 16 new licenses granted by SBA in 1986, and only 13 new licensees in 1987. Many firms were taking a "wait and see" attitude rather than apply for a license while other firms seeing the "handwriting on the wall" began to leave rather than wait for the ax to fall. The result was that the period from 1985-87 represented one of the largest net fall-offs in active SBIC licensees during the history of the program, with a net decrease in active licensees from 391 to 307 -- a 21% reduction in total licensees in just three years!

It is clear that potential organizers of new SBICs are reacting to the enormous uncertainty surrounding the SBIC program. They still question whether a proposal to terminate the program will surface again. If it does, they won't bother to invest their time, money and resources in a dead-end effort. But even if such a proposal does not raise its ugly head again, the damage has been done; and the SBIC program cannot withstand this dismemberment -- either wholesale or piecemeal -- indefinitely.

Without stability in the program, and additional financial resources, there will continue to be a squeeze on the SBIC industry's ability to provide needed equity and long-term capital to small firms. The industry's current rate of investment in small growth companies can only be sustained through the development of a vehicle which will provide a constant, reliable flow of funds to the industry and a stable regulatory environment. Otherwise, the number of operating SBICs will continue to decrease, and the ultimate loser will be our Nation's emerging growth companies who will no longer have access to the crucial source of capital SBICs provide.

Buffeted by these threats to close down the program, destabilizing policies and uncertain access to leverage, we have concluded, as prudent business men and women, that it is absolutely essential to re-structure the SBIC program and bring stability and predictability to our industry.

In the face of indisputable success, we believe it is time to alleviate the financial and regulatory uncertainty that makes it impossible to plan our future and protect our capital investments.

In short, because SBICs are in the business of making long-term investments, they need a reliable partner for the long haul. In order to plan, operate and invest effectively, SBICs need a reliable source of long-term funds and a regulatory environment with long-term stability. The current leverage and regulatory process is no longer serving the needs of small business or the SBIC industry. Continued uncertainties of annual Congressional funding and restrictive allocations of scarce dollars have made the current financial-support process unreliable. In addition, continually changing government regulatory policies have created an unreliable and unstable operating atmosphere, which is counterproductive to the business of long-term investing.

Unless we have a creative vehicle like COSBI to permit the SBIC industry to utilize the full panoply of private sector resources that are available, the SBIC industry's ability to continue to provide financing to small firms is in jeopardy.

SBICs must have access to the capital markets through a financial intermediary that is responsive to the unique needs of small business investment companies. COSBI will give SBICs that facility.

Le me also add that credit for the concept of privatizing the SBIC program should be given to the Congress. In 1967, with great wisdom and foresight, the Congress added a provision to the Small Business Investment Act of 1958 which specifically requires SBA to make:

> ". . . recommendations with respect to the feasibility and organization of a small business capital bank to encourage private financing of small business investment companies . . ."

Mr. Chairman, although SBA has never followed through on this legislative requirement, we are indeed grateful that you and other Members of the Senate Small Business Committee have again taken the initiative to introduce a carefully crafted, well-thought-through COSBI proposal -- clearly reflected in S. 1929 -- to implement the idea of a capital bank for the industry. Not only is this concept consistent with the real needs of the SBIC industry, it is also consistent with efforts this Committee has made to restructure the programs at SBA to permit it to better target its limited resources.

COSBI: A RELIABLE PARTNER FOR SMALL BUSINESS

1. The Concept

COSBI will be a privately owned and managed, special-purpose financial institution, created by an Act of Congress. Its primary mission will be to provide long-term financing and an effective operating environment for SBICs who, in turn, will finance the small, emerging growth companies of tomorrow.

COSBI will operate as a "capital bank" for the SBIC industry, providing SBICs access to a stable source of funds from markets at reasonable cost. Because of its special status as a government-sponsored enterprise, COSBI will be able to sell its securities in the capital markets at highly competitive yields. In turn, COSBI will be able to provide leverage to the SBIC industry on terms which are attractive and structured to meet the unique financial needs of SBICs. This assured source of affordable capital will increase the SBIC industry's capacity to make continued venture capital investments in small growth firms.

In addition, the environmnet in which SBICs operate their companies will materially improve. Specific standards of good business conduct will be required, and abusive practices will be prohibited by statutory mandate, by government oversight and by rules established by COSBI's Board of Directors. The days of constantly changing regulations and ad hoc decisions and arbitrary regulatory actions will be eliminated. Because COSBI will be directed by experienced professionals who have intimate knowledge of the industry, the operating "rules of the road" will be stabilized and their application will become substantially more efficient. SBICs, as long-term investors, will have a reliable system on which they can depend.

2. Public Policy Purpose

A number of important public policy purposes will be served by the creation of COSBI.

Small business will be the primary beneficiary. COSBI will provide small business access to the major capital markets, and, in just a few years, will increase the flow of venture capital to small firms by hundreds of millions of dollars, and perhaps billions.

Because small business is the major job creator and innovator in the American economy, increased venture investments flowing through the new system will create hundreds of thousands of new jobs in a wide variety of industries and thousands of product innovations, technologies and new commercial applications. In turn, millions of dollars in new tax revenues will be produced by the capital formation multiplier effect of new investments in the economy.

In addition, COSBI will produce hundreds of millions of dollars in reductions in Federal budget outlays over the years through elimination of government appropriations to fund the MESBIC program and elimination of the government guarantee of SBIC debentures. At current funding levels, over the next ten years this would save $390 million in direct appropriations no longer needed to finance the MESBIC program, and remove $2.3 billion in contingent liabilities that would result from guaranteeing SBIC debentures. The Government will also benefit by the elimination of SBA's complex financial and regulatory apparatus and its accompanying payroll.

Finally, this country's venture capital system will be greatly enhanced by conversion of the SBIC program to a fully private system. COSBI will provide a new investment climate that will attract hundreds of millions of dollars of new private capital into the SBIC program and small business.

3. Basic Structure of COSBI

COSBI will be a privately owned and managed, for-profit corporation. SBICs will invest $20 million of their private funds and purchase voting common stock in order to provide the equity capital of the corporation.

COSBI will be managed by a 15-member Board of Directors -- 5 of whom will be appointed by the President and confirmed by the Senate, 9 of whom will be elected by voting common stockholders and one of whom will come from the MESBIC Trust. The Board of Directors will set policy for the corporation, and its operations will be carried out by a professional staff hired by the corporation.

Chartered by an Act of Congress, COSBI will have a special set of characteristics which will give it federal "Agency" status. These special features, patterned after those of other government-sponsored corporations such as the Federal National Mortgage Association (FNMA) and the Student Loan Marketing Association (SLMA) will permit COSBI to gain stable and continuing access to funding in the capital markets at affordable prices -- eliminating the need of the Federal Government to appropriate funds or issue government guarantees.

COSBI -- AN EXECUTIVE SUMMARY

Recently NASBIC prepared an Executive Summary of COSBI for its membership. This Summary includes an historical perspective of how COSBI was developed; a discussion of the efforts made to improve the legislation over the version of the bill introduced last Congress; the details of COSBI's basic financial structure and the methodology of its purchase of the SBIC portfolio from the Federal Financing Bank; a discussion of how COSBI will be managed and how it will operate; and a review of the substantial Government oversight of COSBI's operations mandated by the legislation. Appropriate explanatory appendices have been included in the Summary.

Therefore, rather than re-state this detailed explanation of COSBI, which is set forth in great detail in the Executive Summary, I would request that it be made a part of my testimony and incorporated into the hearing record.

ISSUES PREVIOUSLY RAISED BY THE ADMINISTRATION

Although COSBI is consistent with the Administration's stated goals to (1) "privatize" government programs where feasible; (2) reduce government regulation where appropriate; and (3) reduce Federal Government appropriations and government guarantees, the Administration has in the past opposed the enactment of COSBI.

The Administration has raised the following concerns, which we believe are adequately addressed in the current COSBI legislation.

1. The Treasury "Backstop"

Every version of the COSBI legislation introduced in Congress has provided for some form of a financial "backstop" by the U.S. Treasury. This feature was patterned after similar backstop provisions provided to other federally-sponsored agencies, such as FNMA and SLMA.

The purpose of the backstop is to give COSBI better pricing for its securities when it goes to the market. The investment banking community advises us that this Treasury backstop provision is the single most important item to investment managers who determine whether a security qualifies as an investment grade "agency" security; and the absence of such a backstop would severely injure the financial capacity of a new facility like COSBI to sell its securities. Without the backstop, the sale of COSBI's securities would be either virtually impossible or the the pricing so extreme that COSBI's feasibility would be very questionable.

The Treasury backstop provides that if an agency gets into serious financial difficulty, the Federal Government, at the discretion of the Secretary of Treasury, may step in to provide support for the agency until it is restored to a sound financial position.

Treasury has argued that enactment of COSBI would not be true privatization of a government program "due to the extensive financial tie" this backstop provides to the Federal Government.

What Treasury has failed to recognize is that this backstop is not a guaranty by the Federal Government! It is not a line of credit that can be drawn down by the agency! And it is not a contingent liability of the Federal Government! Furthermore, this backstop has never even been used by any government-sponsored agency!

In addition, the COSBI legislation now specifically provides that the use of this backstop authority is subject to the appropriations process, and any discretionary use by the Secretary of Treasury has been eliminated. The backstop provision was re-fashioned in this manner to assure Congress that the backstop did not represent an automatic or guaranteed line of credit to COSBI, and that no financial assistance would be given to COSBI without the direct approval of Congress. At the same time, to give additional comfort to the Administration, this backstop provision was reduced by half to $500 million and would represent by far the lowest backstop ceiling of any government agency.

The House Budget Committee also specifically determined that this backstop proposal as drafted would not be scored as additional budget authority or outlays.

2. Purchase of the FFB Portfolio

Each version of the COSBI legislation has had a provision under which the corporation would purchase the outstanding SBIC debentures held by the Federal Financing Bank (FFB). Generically, this transaction involves a governmental "sale of assets" which is analogous to the asset sales suggested by the Administration as a way to achieve budget savings.

All of the asset sales proposed by the Administration appear to be randomly selected, with no substantive, program-related purpose. COSBI's acquisition of the SBIC debentures held by FFB, on the other hand, serves a very important purpose for the SBIC program, small business and COSBI. This transaction will give COSBI an initial asset base and immediate recognition in the capital markets, factors the investment banking community feels are very important to the ultimate success of COSBI.

The Administration has in the past suggested selling SBA and other loan assets for as low as 20 cents on the dollar. These proposals have been heavily criticized as penny-wise and pound-foolish "fire-sales" because, while they create the appearance of short-term savings, the government actually ends up losing a significant part of the long-term value of the assets being sold.

The legislation provides a systematic process under which the fair market price for the FFB portfolio would be determined either by agreement between the Secretary of the Treasury and COSBI's Board, or, alternatively, by a majority vote of three independent investment advisers.

Accordingly, any concern that might exist over whether the Federal Government will receive fair, market value for the FFB portfolio has clearly been dealt with in the statute.

I might note parenthetically that the decision to structure the FFB purchase "with recourse" is obviously one to be made by Congress and not the industry. We have, however, also explored with the investment banking community the option of purchasing the portfolio on a non-recourse basis, and would be willing to do so if Congress were to decide to change the structure of the sale. I would only point out that a "non-recourse" sale would result in a substantial discount in the value of these assets and a substantial decrease in the purchase price COSBI would be able to pay.

3. COSBI's Debt to Capital Ratio

Treasury took the position that there should be a statutory limit on COSBI's borrowing authority, i.e. that it should not have an unlimited authority to borrow.

We have assumed all along that COSBI's Board of experienced financial executives, COSBI's performance and the normal restraints imposed by the capital markets would control COSBI's capacity to issue debt. We would prefer to rely on market forces; however, we are sympathetic to the objective being sought by Treasury.

Consequently, the COSBI legislation has now been modified so that, like FNMA, it requires that the corporation's debt to capital ratio never exceed 15 to 1. The financial models prepared by Arthur Andersen & Co., which have been submitted to the Committee, include a projection of COSBI's financial performance for a 15-year period after startup. During that period, COSBI's debt to capital ratio would never exceed 7 to 1 -- a ratio that should satisfy even the most conversative analysts regarding the viability of COSBI's operations.

4. Government Oversight of COSBI

The Administration has also urged that there be substantial Government regulation and control over the operations of COSBI. The industry has worked hard with Congressional staff to design appropriate authority for effective

Federal Government oversight of COSBI to assure that the public policy objectives of the legislation are carried out.

The Executive Summary of COSBI submitted as part of my testimony spells out in detail the extensive government regulations and regulatory framework under which COSBI would be required to operate. I've also attached to my testimony as Exhibit VI an additional review of the substantial regulatory structure the industry has proposed for COSBI which we believe is appropriate and sufficient to protect the government's interest.

This extensive regulatory framework includes public appointees on the Board; an annual audit of COSBI by an independent CPA; access by Treasury to COSBI's books and records, Treasury authority over COSBI's issuance of securities and Treasury review of COSBI's financial condition; SBA access to COSBI's books and records, authority to review COSBI's financial performance, or other matters it deems appropriate, and authority to direct COSBI to prepare reports on any aspect of COSBI's operations; annual financial and program reports on COSBI to the Senate and House Small Business Committees, the President and SBA Administrator; and GAO review of COSBI's performance. In addition, the regulation of SBIC business practices by way of a contract between COSBI and each SBIC specifically requires annual financial and bi-annual compliance audits of SBICs by independent CPAs or COSBI auditors. I should also point out that in order to insure that the program will be regulated in a manner consistent with the design of the current program, the major regulations that currently govern the operations of SBICs have been codified in very specific terms in the statute.

Mr. Chairman, I would also like to emphasize that the current COSBI bill contains a new, substantive regulatory provision that was not in prior versions of the bill -- one that authorizes the SBA Inspector General to audit individual SBICs. Since the specific circumstances under which the I.G. can exercise this authority are clearly spelled out in the statute, and his authority is subject to a reasonable and probable cause standard, the SBIC industry is generally willing to accept this provision -- but with one recommended modification. We would hope and urge that the Senate adopt the language of the House bill which restricts this authority solely to individual SBICs that have outstanding debentures guaranteed by the SBA. Obviously, the singular reason for giving the I.G. this type of audit authority is for protection of the government's financial interest. When debentures guaranteed by the SBA have been paid off by an individual SBIC, or if an individual SBIC has no debentures guaranteed by the Federal Government, there is no financial interest that the government has to protect. Therefore, it is our opinion that under those circumstances any audit responsibility of individual SBICs should be solely the responsibility of COSBI.

We are convinced that this approach to oversight and regulation is exhaustively sufficient and the right one, and that it is a sound, reasonable compromise that will work and produce the results desired by the Committee. We believe the industry's proposed regulatory structure is more than sufficient to protect the government's interests, yet it is not so intrusive that it would destroy the private-market characteristics of the program.

Consequently, Mr. Chairman, there is one provision in the Senate bill which the industry would find it very difficult, and indeed, virtually impossible toaccept as part of the regulatory framework for COSBI: this is the provision giving SBA rulemaking authority over COSBI's operations. Based on past experience and countless difficulties with SBA, giving the Agency such authority is "creating a disaster waiting to happen."

I have already discussed earlier in my testimony the problems the industry has had over the years with SBA's regulation of the program. Attached to my testimony as Exhibit VII are additional examples of regulations SBA has proposed over the years harmful to the program. Giving SBA rulemaking authority would simply mean a continuation of the battle to ward off attempts by the government to mis-regulate and disrupt the program. If SBA rulemaking authority is retained in the COSBI legislation, it will represent a major disincentive to SBICs to participate in COSBI's formation and capitalization and a clear negative in terms of new capital flowing into the program in the future. In short, in my opinion, COSBI will never be organized and made operational if SBA retains rulemaking authority over the process.

From the regulatory perspective, we are convinced that the professional industry leadership elected to COSBI's Board of Directors, including the Directors appointed by the President and confirmed by the Senate, will do a far better job of regulating the business practices of SBICs than any group of government regulators. As a practical matter, the Administration lacks the technical expertise the corporation will have to promulgate fine-tuned substantive regulations governing day-to-day transactions. When the knowledge and awareness of professional SBIC managers is coupled with an absolutely compelling financial and professional self-interest in keeping the industry free from abusive practices, those factors create an overwhelming incentive for consistent and diligent oversight and strong enforcement of proper business practices.

CONCLUSION

Mr. Chairman and members of the Committee, I wish to conclude by stating that we believe that COSBI represents a bold, even historic, step for our industry. Over the past 30 years, SBICs and MESBICs have built an impressive record of developing the nation's most job-generating and innovative small businesses. But now the industry is at a critical crossroads that will determine its future and the future of many small firms our industry is designed to assist.

Under COSBI, SBICs and MESBICs will assume the risk of operating in the private marketplace in return for the chance to eliminate the chronic problems which limit our effectiveness. Both NASBIC and NAIC, and our member companies, are convinced that if COSBI becomes a reality everyone will be a winner.

Small business historically has been foreclosed from access to the major capital markets. Under COSBI the private marketplace will provide hundreds of millions of dollars for venture capital investments in small firms. The impact of these investments on our economy will be enormous in terms of the kind of job creation, new products and increased innovation that only small business can produce. In addition, the Federal Government will save hundreds of millions of dollars over the years in direct appropriations no longer needed to finance the MESBIC program; remove billions of dollars in contingent liabilities by elimination of the government guarantee for SBICs; and benefit from increased tax revenues produced from the profits, operations and employment of small growth firms. Finally, we would hope that our industry would experience significant growth under COSBI, to the ultimate benefit of the American economy.

Mr. Chairman, this concludes my prepared statement. I would be pleased to respond to any questions from the Committee. Thank you.

EXHIBIT I

DISBURSEMENT OF VENTURE CAPITAL INVESTMENTS

TOTAL AMOUNT INVESTED IN SMALL BUSINESSES — $7 BILLION

TOTAL NUMBER OF FINANCING — 85,000

(Through March 31, 1987)

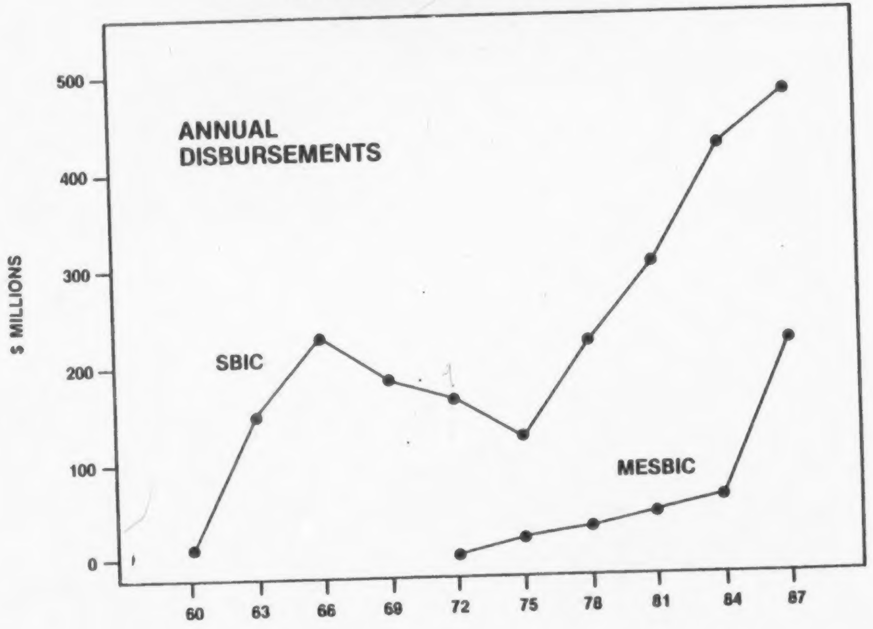

EXHIBIT II

Emerging Growth Companies Financed by the SBIC Industry
November 1987*

CALIFORNIA

Mountain Computer, Inc. - Scotts Valley, California
SBICs: PCF Venture Capital Corp., San Jose Capital
Manufacturer of disk and tape data storage systems. Combination debt and equity financing. In five years, the number of employees increased from 50 to 270. Sales volume rose from $3 MM to $54 MM. Mountain paid taxes of $2 MM in 1986; after-tax profits were $2.5 MM.

Stars to Go- Fresno, California
SBIC: VK Capital
Company rents video cassette movies through convenience store video centers. Has contracts with 6,800 convenience stores for centers. In less that two years, with equity financing from an SBIC, the company grew from 116 to 520 employees Sales volume rose from $1.6 MM to $22.7 MM.

COLORADO

Consumer Health Services - Boulder, Colorado
SBICs: Allied Capital Corp., Capital For Business, Atlantic Business Partners .
Health care information service that links consumers with health care practitioners. 1984 financing was convertible debt. Without SBIC financing, company would have gone out of business. Number of employees increased from 15 to 250. Sales volume rose from $2 K to $8 MM. After-tax profits now at $250 K.

CONNECTICUT

International Marine Industries- Stamford, Connecticut
SBICs: Croyden Capital, American Security Capital
Manufacturer, wholesaler and marketer of marine products and accessories to recreational boating community. Company had run out of credit and was unable to raise money with Wall Street bankers. With 1985 convertible debt financing from SBICs, went from 35 employees to 250. Sales volume from $6.9 MM to $22.7 MM. Taxes paid went from $138 K to $278 K. After-tax profits: $244 K to $722 K.

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* Statistics cited in company descriptions are for the period ending December 1986.

FLORIDA
Elexis Corp.- Miami, Florida
SBIC: Southest Venture Capital
Company develops, manufactures and markets technologically innovative consumer electronic products for sports/fitness and pet care markets. Without second round equity financing from Southeast Venture in 1981, Elexis may not have survived early losses. Went from two employees to 80. In five years sales volume climbed to $8.2 MM. Taxes paid were $522 K. After-tax profits - $908 K.

GEORGIA
Southern Medical Imaging- Atlanta, Georgia
SBICs: North Riverside Capital, Hickory Venture Capital,
Heritage Capital Corp., Invesat Capital Corp.,
UV Capital, James River Capital
Provide diagnostic medical imaging services to patients of contracting hospitals and other health care facilities. In 1985 SBICs provided the capital necessary to purchase additional equipment, thus allowing the company to increase its client base and coverage. In two years, went from 21 to 45 employees. Sales volume went from $2.2 MM to $3.6 MM. After-tax profits at $454 K.

HAWAII
Osteon Inc. - Wahiawa, Hawaii
SBIC: Bancorp Hawaii SBIC
Manufacturer of a bone densitometer, used in diagnosing and monitoring osteoporosis. SBIC's equity financing support in 1985 provided credibility for the company in seeking trade and bank credit. Went from one employee to 14. 1986 sales volume was $1.6 MM, after-tax profits were $20 K.

ILLINOIS
Newtrend Group, Ltd.- Oak Brook, Illinois
SBICs: Frontenac Capital, First Capital Corp. of Chicago
Provides proprietary software systems to the banking and savings & loan industries. Two operating subsidiaries have been transformed into full-line computer service companies. 1984 equity financing included common and preferred stock and warrants. Employees went from four to 219. Sales volume was $33.7 MM. $3.1 MM tax provision. After-tax profits- $2.6 MM.

KANSAS
Landmark Hotel Corporation- Topeka, Kansas
SBICs: Kansas Venture Capital, KS Development Credit Corp.
Landmark is manager, leaser and developer of hotel properties. Financing- subordinated debt with equity options. 1984 financing by SBICs helped make company "bankable." Number of employees went from 55 full-time and 530 part-time, to 1,100 full-time and 2,400 part-time. Sales volume rose from $139 K to $11.8 MM. After-tax profits were at $335 K.

LOUISIANA

Advanced Polymer Systems- Lafayette, Louisiana
SBIC: Louisiana Equity Capital Corp.
Manufactures and markets patented specialty chemicals for use in the pharmaceutical and cosmetic industries. 1985 financing included preferred stock. Louisiana Equity a major participant with other out-of-state non-SBICs. Number of employees- now 40, up from 20. Sales volume was at $326 K.

MASSACHUSETTS

Apollo Computer Inc. - Chelmsford, Massachusetts
SBIC: California Partners
Apollo manufactures, designs and markets engineering work stations. Without equity financing from SBIC, owner would have been unable to start company. In seven years, went from one to almost 5,000 employees. Sales volume is at $390 MM. Taxes paid - $10 MM. After-tax profits are at $10 MM.

MICHIGAN

Irwin Magnetic Systems, Inc.- Ann Arbor, Michigan
SBIC: Doan Resources
Manufactures a series of tape back-up units for microcomputers. Design of the units doesn't require controller, making it easy to use the tape drive without modifying most microcomputers. Equity financing made it possible to form Irwin by acquiring assets from a compnay which failed when trying to do something similar. In four years, the number of employees rose from 16 to 450. Sales volume in 1986 was $13.7 MM; taxes paid- $448 K; after-tax profits: $942 K.

ALC Communications- Birmingham, Michigan
SBICs: Michigan Capital & Service, National City Capital
New England Capital
Offers discount long distance telephone service nationwide to commercial and residential customers. 1983 financing- convertible and subordinated debt. Company's start-up capital raised from four SBICs. In six years, number of employees rose from 5 to 1,800. 1986 sales volume was $440 MM.

Nastec Corporation - Southfield, Michigan
SBICs: Regional Financial Enterprises, Norwest Growth, Michigan Capital, Doan Resources, Commercial Capital, Northstar Ventures, Control Data Capital
Develops and sells IBM PC compatible software which automates design and development of large software projects. 1983 financing- common stock. Company's initial financing received from six SBICs. Went from 15 to 90 employees. 1986 sales volume was at $7 MM.

MINNESOTA

Hutchinson Technology, Inc.- Hutchinson, Minnesota
SBIC: Frontenac Capital
HTI is a precision manufacturing source for leaders in computer peripheral and other technology-driven markets. 1982 common stock financing. Number of employees went from 328 to 1,513. Sales volume rose from $14.8 MM to $47.1 MM. Taxes paid increased from $925K to $1 MM. After-tax profits rose from $1.1 MM to $2.7 MM.

NEW JERSEY

Keystone Camera Products Corp.- Clifton, New Jersey
SBICs: Harvest Ventures, California Capital, Unicorn Ventures, Bridge Capital, Northwest Growth Fund
Keystone manufactures popular price, easy-to-use 35 millimeter and cartridge cameras. 1979 financing- equity initially; then debt plus equity. Financing allowed company to restructure. Number of employees - 900. Sales volume at $40.5 MM.

NEW YORK

Comptek Research Inc.- Buffalo, New York
SBIC: M & T Capital Corp.
Provides technical services, computer systems, hardware and software to U.S. Dept. of Defense in connection with computer controlled tactical systems. Financing in 1985 -- common stock with later rounds of subordinated debt. M & T provided overwhelming majority of seed capital. Number of employees went from 4 to 600. Sales volume rose from $286 K to $28 MM. Taxes paid- $500 K and after-tax profits are at $600 K.

Datarex Systems, Inc.- Cheektowaga, New York
SBIC: Rand SBIC Inc.
National specialty wholesale distributor of computer and word processing supplies and accessories. Financing was 8-year term loan of $300 K. In over a year, number of employees went from 40 to 73. Sales volume rose from $6 MM to $25 MM. Taxes paid rose from $19 K to $383 K and after-tax profits rose from $74K to $450 K.

NORTH CAROLINA

Tangram Systems, Inc.- Cary, NC
SBICs: Kitty Hawk Capital, NCNB Capital, Hillcrest Group Hickory Venture Capital, Heritage Capital Corp.
Manufacturer of computer software. 1985 equity financing. Company could not gear up for new product without SBIC financing. In less than 2 years, company went from 5 to 40 employees. Sales volume increased from $570 K to $3.5 MM.

Franchise Enterprises Inc.- Rocky Mount, North Carolina
SBICs: UV Capital, Greater Washington Investors, PNC Capital, Heritage Capital, North Riverside Capital, Reedy River Ventures
Company is third largest Hardee's franchisee in country. Financing was subordinated debt with warrants. SBICs provided financing for growth when commercial banks would not. Nine months after initial SBIC investment, company grew from 2,600 employees in 70 stores to 3,230 employees in 91 stores. Sales volume rose from $57 MM to $70 MM. After-tax profits jumped to $2.6 MM from $650 K.

OHIO

Action Auto Rental - Solon, Ohio
SBICs: National City Capital
Action Auto is an insurance replacement automotive rental business. In 1983, SBIC provided start-up capital in form of equity financing and second round capital. In three years, went from four employees to 330. Sales volume was at $19.5 MM. Taxes paid in 1986 were $278 K. After tax profits were $1.8 MM.

PENNSYLVANIA

dbo corporation- York, Pennsylvania
SBICs: UV Capital, James River Capital
Manufacturer of air handling components for air conditioning market. In 1985, financing of subordinated debt with warrants provided initial working capital. In 15 months, number of employees rose from three to 106. At the end of 1986, sales volume was $10 MM.

Airgas, Inc.- Radnor, PA
SBIC: Meridian Capital Corp.
Manufacturer of products for industrial gas industry. 1982 equity financing - preferred stock. Meridian provided part of original equity to purchase U.S. Airgas, Inc., which was later merged into Airgas Inc. In five years, employees rose to 875 from 17. Sales volume rose from $3.5 MM to $130 MM; taxes paid rose from $75K to $2.4 MM. After-tax profits rose $182 K to $2.4 MM.

RHODE ISLAND

Pearson Yachts Corp.- Portsmouth, Rhode Island
SBICs: UV Capital, Reedy River Ventures
Manufacturer of fiberglass auxiliary sailing yachts. 1986 financing was debt/equity combination. Because of company's operating record, equity support was difficult to come by. Management needed independent backing of one or more financially astute institutional type investors. Although number of employees went from 248 to 202, the company went from an operating loss to after-tax profits of $13,100.

TENNESEE

American Matrix Inc.- Knoxville, Tennessee

SBICs: Kitty Hawk Capital, TA Associates, Venture First,
Citicorp Capital

Company does research & development and manufacturing of high tech advanced ceramic materials with many potential defense uses. 1986 equity financing. Company was out of money; bank overextended, needed extensive R & D effort. (SBIC was $1.2 K of $3.65 MM venture financing.) In a year, employees rose from 50 to 70. Sales volume increased from $3.5 MM to $6.0 MM.

TEXAS

Microdynamics- Dallas, Texas

SBICs: Orange Nassau Capital, Hickory Venture Capital
Moramerica, Capital for Business, Sunwestern Group,
Texas Capital, Republic Venture Group

Company produces and markets a CAD/CAM system for apparel and footwear companies. Equity financing with 9% dividend was key to growing the computer-aided-design division after first product failed. In three years, number of employees increased from 35 to 125. Sales volume increased to $11.7 MM from $1.4 MM. Went from operating loss to after-tax profits of $66 K.

Kent Electronics Corp.- Houston, Texas

SBIC: The Franklin Corp.

Company is a specialty electronics distributor and custom contract manufacturer. Without 1973 SBIC financing, management buyout could not have been accomplished. In 14 years, number of employees grew from 15 to 150. Sales volume went from $1 MM to $18 MM. Paid taxes in 1986 of $470 K. After-tax profits were at $574 K.

VERMONT

Artec Distributing Inc. - Shelburne, Vermont

SBICs: Winfield Capital Corp., AMEX Capital Corp.
Tappan Zee Capital Corp.

Distributor of pre-recorded video cassettes, compact discs, related products. 1981 debt financing allowed company to establish video cassette distribution business and enlarge physical facilities. Financing included 6-year $300,000 loan, with equity options attached. In eight years, company has gone to 200 employees from 20. Sales volume increased from $4.3 MM to $75 MM. Taxes paid rose from $1,400 to $1 MM. After-tax profits rose from $47 K to $1 MM.

VIRGINIA

Riverton Investment Corp.- Riverton, VA

SBICs: Hillcrest Group, Interfirst Venture Corp., White River Capital, Reedy River Ventures, Kitty Hawk Capital

Company manufactures portland and masonry cements. 1983 financing was common stock and subordinated debt. No other funds were interested in providing the equity for a leverage acquisition in a cyclical industry. Sales volume went from $10.3 MM to $50 MM.

EXHIBIT III

AVERAGE SIZE OF FINANCING PER COMPANY
(1986)

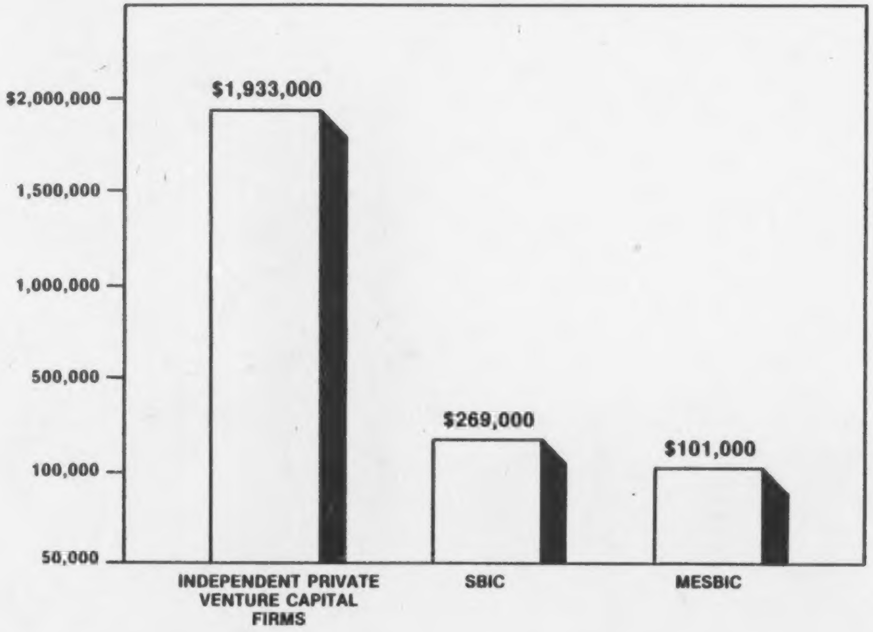

EXHIBIT IV

DISTRIBUTION OF SBIC INVESTMENTS IN ALL 50 STATES (1980-1986)

DOLLAR AMOUNT OF SBIC FINANCING FOR EACH STATE

TOTAL SBIC INVESTMENTS: $2,699,515,226

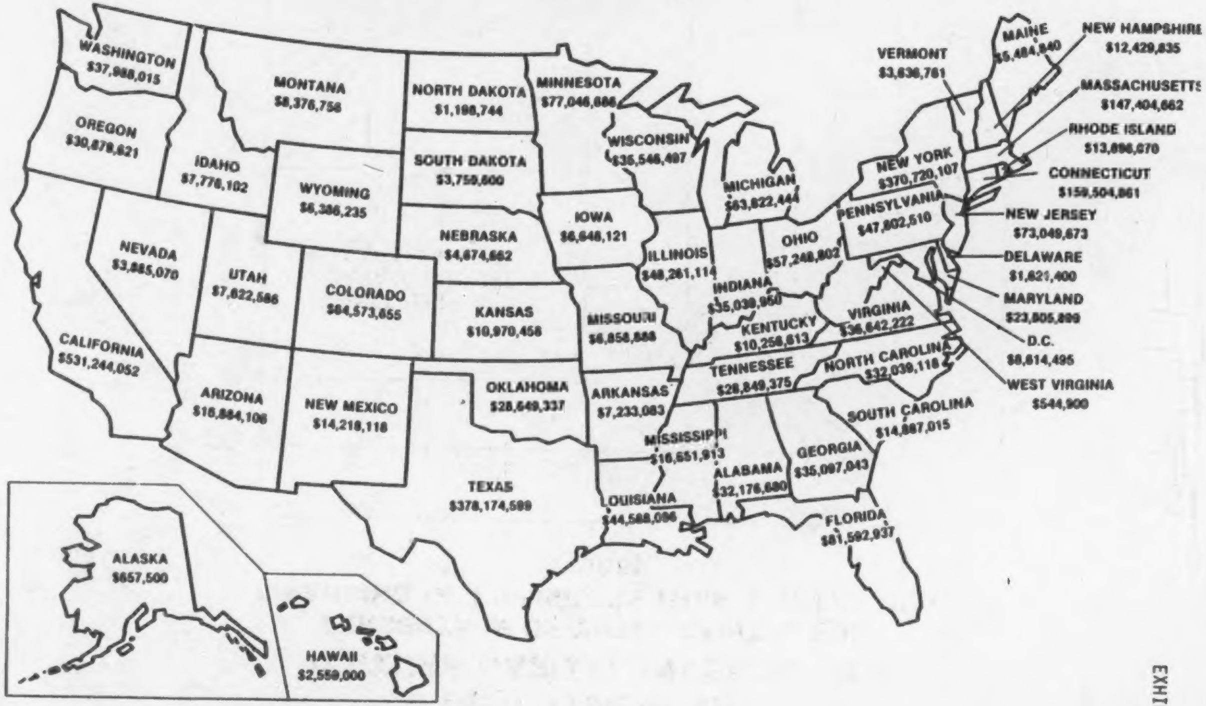
WASHINGTON $37,988,015
OREGON $30,878,621
CALIFORNIA $531,244,052
IDAHO $7,776,102
NEVADA $3,885,070
MONTANA $8,376,756
WYOMING $6,386,235
UTAH $7,822,586
ARIZONA $16,884,106
COLORADO $84,573,655
NEW MEXICO $14,218,118
NORTH DAKOTA $1,198,744
SOUTH DAKOTA $3,759,600
NEBRASKA $4,674,662
KANSAS $10,970,458
OKLAHOMA $28,649,337
TEXAS $378,174,589
MINNESOTA $77,046,886
IOWA $6,648,121
MISSOURI $6,858,888
ARKANSAS $7,233,083
LOUISIANA $44,588,096
WISCONSIN $35,546,497
ILLINOIS $48,261,114
MISSISSIPPI $16,651,913
MICHIGAN $63,822,444
INDIANA $35,038,950
KENTUCKY $10,258,613
TENNESSEE $28,849,375
ALABAMA $32,176,680
OHIO $57,248,802
GEORGIA $35,097,043
FLORIDA $81,592,937
PENNSYLVANIA $47,802,510
VIRGINIA $36,642,222
NORTH CAROLINA $32,039,118
SOUTH CAROLINA $14,887,015
NEW YORK $370,720,107
VERMONT $3,636,761
MAINE $5,484,840
NEW HAMPSHIR $12,429,835
MASSACHUSETT $147,404,662
RHODE ISLAND $13,896,070
CONNECTICUT $159,504,861
NEW JERSEY $73,049,673
DELAWARE $1,621,400
MARYLAND $23,805,899
D.C. $8,814,495
WEST VIRGINIA $544,900
ALASKA $657,500
HAWAII $2,559,000

EXHIBIT V

DEPLOYMENT OF VENTURE CAPITAL INVESTMENTS

PERCENTAGE OF TOTAL CAPITAL FOR FINANCING OF FIRMS LESS THAN 3 YEARS OLD

(1986)

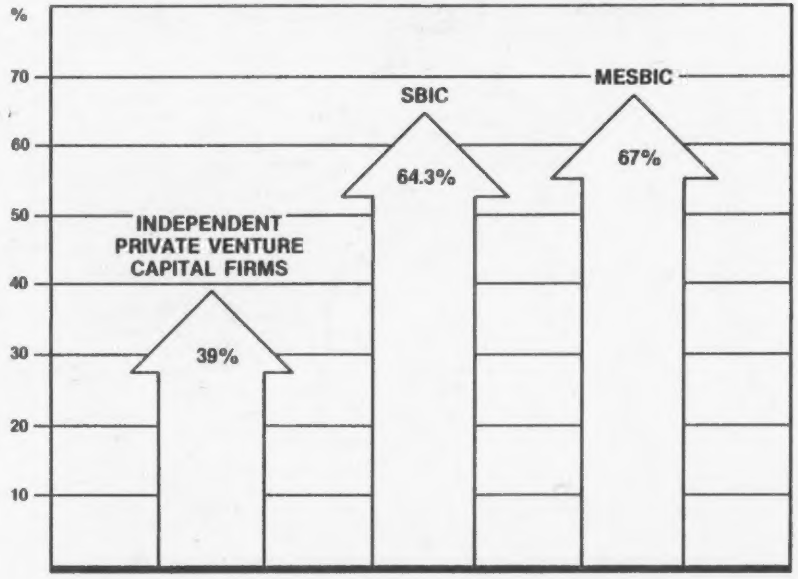

EXHIBIT VI

Regulation and Oversight of the SBIC Program Under COSBI

A. Licensing

1. Basic Standards Codified - The basic qualification standards for licensing are codified in the statute. To qualify, an SBIC must have:

a. a minimum private capital of $1 million,

b. owners and managers with sound business reputations and character, and

c. the probability of successful operations, including adequate profitability and financial soundness.

2. Additional Qualification Requirements - The statute also directs COSBI to establish such additional qualification criteria for an SBIC to do business with the corporation as may be appropriate. These criteria will be subject to SBA and Congressional review.

B. Regulation of SBIC Business Practices

1. Regulations Codified - The major regulatory restrictions on SBIC business practices are clearly enumerated in the statute. These include:

a. Prohibition against conflict of interest transactions,

b. Restriction of investments to only qualified small business,

(Note - the size standard itself is codified in the statute),

c. Prohibition against control of small firms,

d. Required diversification of investment risk, i.e., an SBIC can invest no more than a 20% of its private capital in any one small business,

e. Prohibition against investments in passive businesses, foreign companies, re-lending activities, or the acquisition of real estate, and

f. Prohibition against engaging in unlawful or non-SBIC activities (i.e., operating other types of businesses).

2. Public Board Members' Approval of Major Rules - The major rules adopted by COSBI to implement the statutory restrictions governing the operations of SBICs (i.e., those codified in the statute) require the approval of not less than 3 of the 5 Board members appointed by the President and confirmed by the Senate.

3. Approval of Non-Major Rules - COSBI's rules governing the ordinary aspects of SBIC operations require the approval of a majority of COSBI's Board of Directors.

4. Conduct Governed by Contract - SBICs are required to enter into a contract with COSBI, under which they agree to abide by COSBI's rules governing SBIC business practices. The rules noted above and the enforcement provisions noted below will be incorporated into these contracts.

C. Oversight, Audits and Investigations of SBIC Business Practices

1. COSBI Audits and Investigations - The statute mandates that COSBI exercise due diligence in the oversight, auditing and investigation of SBIC business practices. COSBI will have its own expert staff to carry out these functions, supplemented by independent CPA audits of each SBIC. In addition, a special Regulatory Compliance Committee of the Board of Directors will provide policy direction and oversight for these activiites.

2. Biannual Compliance Audit of SBICs - The statute requires a biannual compliance audit of each SBIC by an independent CPA or by COSBI.

3. SBA Oversight - SBA has review authority over all of COSBI's operations, including qualification of SBICs to do business with COSBI, rules or regulations governing the operations of SBICs and "such other matters as the Administrator deems appropriate."

4. SBA Access to Books and Records - SBA has access to all of COSBI's books and records, including all financial and compliance audits of individual SBICs.

5. COSBI Reports to SBA - SBA is given specific authority to require COSBI "to make such reports as the Administration deems desirable."

6. SBA Annual Report to Congress - SBA must prepare an annual report for the Congress and the President on COSBI's operations and activities.

7. SBA Inspector General Access to Books and Records - The Inspector General of SBA has access to all COSBI records, including all financial and compliance audits of SBICs.

8. SBA Inspector General Investigations of SBIC Business Practices - The Inspector General of SBA is authorized to investigate an individual SBIC which has an outstanding SBA-guaranteed debenture, where it can be shown that probable cause exists to believe that an SBIC has committed civil fraud or has violated a federal criminal statute. The IG is empowered to establish probable cause standards.

9. GAO Access to Books and Records - GAO, as Congress' agent, has access to all of COSBI's books and records, including all financial and compliance audits of SBICs.

10. GAO Report to Congress - GAO is required to submit a report to Congress by January 31, 1991, on how well COSBI has achieved the purposes of the Act. Presumably, this will include an assessment of SBIC business practices.

11. Committee Oversight - The statute specifies that the Small Business Committees of Congress have access to all of COSBI's books and records, including all reports to COSBI from SBICs and audits of SBICs.

D. Enforcement of SBIC Compliance

1. Civil Enforcement Powers - COSBI will have access to all appropriate civil remedies where an SBIC has breached its contractual agreement with COSBI, including acceleration of debt in cases of default, actions to enforce contractual conenants and initiation of litigation against the SBIC.

2. Statutory Enforcement Powers - The statute directs COSBI to adopt measures to assure compliance with its rules and regulations, and provides COSBI with several specific enforcement powers, including:

   a. Termination or suspension of agreements between COSBI and an SBIC,

   b. Termination of an SBIC's qualification to do business with COSBI,

   c. Assessment of penalties against an SBIC or its officers or directors,

   d. Removal or suspension of officers or directors, or

   e. In appropiate cases, referral of violations to SBA for investigation, or referral to the U.S. attorney.

3. IG Action on Investigations - In those cases where the IG's investigations result in findings of civil fraud or criminal violations, the IG could would make appropriate referrals for litigation or prosecution.

E. Oversight and Review of COSBI's Regulatory Performance

1. SBA Oversight - SBA has review authority over all of COSBI's operations, including the standards it sets for SBICs to do business with COSBI, the rules or regulations it establishes for SBIC business practices and "such other matters as the Administration deems appropriate."

2. SBA Access to Books and Records - SBA has access to all of COSBI's books and records, including those relating to regulatory activities.

3. COSBI Reports to SBA - SBA is given specific authority to require COSBI "to make such reports the Administration deems desirable," including reports on any regulatory actions.

4. SBA Annual Report to Congress - SBA must prepare an annual report for the Congress and the President on COSBI's operations. This report will include an assessment of COSBI's regulatory activities.

5. SBA Inspector General Access to Books and Records - The Inspector General of SBA has access to all of COSBI's books and records, including all materials relating to regulatory activities.

6. GAO Review - The Small Business Committees have specific authority to direct GAO to review any aspect of COSBI's regulatory operations at any time, and GAO has full authority to review COSBI's regulatory operations.

7. GAO Audit - COSBI is subject to a GAO audit of its regulatory actions at any time at the request of either Small Business Committee of Congress.

8. GAO Report to Congress - GAO is required to submit a report to Congress by January 31, 1991, on how well COSBI has achieved the purposes of the Act. This will include an assessment of COSBI's regulatory performance.

9. Committee Oversight The Small Business Committees have full, ongoing legislative oversight of COSBI's operations, including access to all of COSBI's books and records relating to regulatory activities.

F. Oversight and Review of COSBI's Financial Performance

1. Restriction on COSBI Debt - The statute specifically restricts COSBI from incurring excessive debt by setting a maximum debt to capital ratio of not more than 15 to 1, which is the same as the statutory FNMA debt restriction.

2. Treasury Approval of COSBI's Issuance of Securities - All obligations issued by COSBI must be approved by the Secretary of the Treasury. This conforms with Treasury's authority to control the issuance of securities by other GSEs.

3. Annual Financial Audit of COSBI - The statute requires that COSBI be audited each year by an independent CPA or Treasury.

4. Treasury Access to Books and Records - Treasury has access to all of COSBI's financial books and records.

5. Treasury Financial Report on COSBI - The statute requires that Treasury provide Congress and the President with an annual audit report on COSBI, with information on the corporation's operations and financial condition, and any appropriate recommendations.

6. SBA Access to Books and Records - SBA has access to all of COSBI's financial books and records.

7. SBA Inspector General Access to Books and Records - The Inspector General of SBA has access to all of COSBI's financial books and records.

8. Committee Access to Books and Records - The Small Business Committees have access to all of COSBI's financial books and records.

9. GAO Access to Books and Records - The GAO has access to all of COSBI's financial books and records.

10. GAO Audit - COSBI is subject to a financial audit by GAO at any time at the request of either Small Business Committee.

11. GAO Report to Congress - GAO is required to submit a report to Congress by January 31, 1991, on how well COSBI has achieved the purposes of the Act. This will include an assessment of COSBI's financial performance.

EXHIBIT VII

Examples of SBA Regulations Harmful to SBICs

1. Forced Equity Investments - In 1981, and several times since then, SBA has proposed regulations which would force all SBICs to make a minimum, fixed percentage of their investments in straight equity investments. SBA's rational is based on the theoretical concept that every SBIC should have a "balanced" portfolio. The realities of the marketplace, however, dictate otherwise. As a matter of investment policy, and in response to the types of deals the prefer, many successful SBICs have portfolios with straight loans and/or debt securities with equity features, and no straight equity deals. While the industry has been successful to date in keeping this regulatory change off the books, it remains a continuing threat to sound SBIC business practices.

2. Forced Portfolio Diversification by Industry - SBA has also proposed on several occasions that SBICs be required to invest in a diversified range of industries, and, accordingly, be precluded from specialized investments. This proposal is based on SBA's theoretical concept that such diversification would reduce the risk of loss to the SBIC and SBA as a creditor. Here again, the proposal flies in the face of reality. Many SBICs have been quite successful primarily because they have invested in a limited number of industry groups where the SBIC managers have highly specialized knowledge and expertise. Here again, we have been able to keep this regulation off the books, but it remains a constant and uncertain treat to SBIC managers, and new licensees.

3. Increased SBA Fee Charges and Reduced SBA Guarantys - In 1981, SBA imposed by regulation a 1.18% "users fee" charge on all SBIC borrowings from SBA, together with a series of new or increased fees for licensing and processing actions by SBA, ranging from $250 to $5,000 per transaction. The industry took the position at the time that it was appropriate for a private enterprise program like ours to be on a "pay-as-you-go" basis, and we accepted the concept. At the same time, we argued that the fee structure was too high, in that it produced revenues for SBA that exceeded their total costs to administer the SBIC program. Despite our objections, the regulations were imposed.

Recently, SBA proposed a 1% increase in the user fee and a 60% increase in fees charged for SBA's audit of SBICs. The industry has argued vehemently against these increased charges as unjustified and unwarranted. At the same time, SBA also proposed to reduce the level of its guaranty of SBIC debentures sold in capital markets from 100% to 90%. Such a change would either make the notes unmarketable or would increase the pricing to a point that the funding process would become very costly and unattractive to the SBIC industry.

The above noted changes are still pending.

4. Partnership Regulations - In response to urgings by the industry, in 1979 Congress amended the SBIC statute to allow SBICs to be organized as partnerships. Prior to that time, SBICs could only be corporations. For tax, liability and other reasons, we fully believed the partnership-SBIC format would be a very attractive vehicle for substantial new investment in SBICs and reinvestment in small business.

It took SBA 2 years to produce regulations allowing the organization of SBICs as partnerships. In addition, the regulations produced by SBA were so highly restrictive in several respects that many interested investors simply took a walk and invested their funds elsewhere. For example, SBA'a regulations require that every applicant for a partnership SBIC secure a ruling from the IRS that it is qualified as a partnership for tax purposes. This requirement was put into effect over the industry's objections, and despite the fact that IRS advised SBA that they were satisfied with an opinion of counsel on this point and did not, as a matter of IRS practice, issue such rulings. Each partnership SBIC applicant is now required to obtain such a ruling, the IRS reluctantly and very slowly now issues them, but the process normally takes 6 months or more.

In addition, the partnerhip regulations SBA put on the books in 1981 left a laundry list of open issues. To address these issues, in 1983, the industry formed a task force of lawyers, accountants and SBIC managers skilled in partnership matters. That group developed a detailed set of recommendations to resolve the open issues and presented them to SBA in early 1884. To date, SBA has taken no action on these recommendations. As a result, partnership-form SBICs are operating in the blind (or subject to ad hoc policy decisions by SBA) in several critical areas, such as their ability to distribute profits which will enable limited partners to meet their tax liabilities on such profits.

5. Cost-of-Money - This is the industry word of art for SBA's usury limitation on what an SBIC can charge a small business. SBA is authorized (but not mandated) by statute to set a cost-of-money limit on SBIC financings. The industry has argued for years that these charges should be set by free negotiation in the marketplace, but SBA has not had sufficient political guts to implement such a policy.

To the contrary, in 1981, SBA revised its cost-of-money regulation in such a way that it is now so complex-as to be almost impossible to comprehend. Far from a simple interest rate ceiling, the regulation now (1) covers any and all charges made by the SBIC related to the financing, including interest, discounts, points, fees, commissions, closing costs and "any other thing of value given"; (2) it involves proration of charges over the life of the loan; (3) it has a series of exceptions for specialized fees; (4) it has a complex retroactive proviso forcing repayment to the small business of certain "unearned charges" in the event of prepayment; and (5) it requires the application of a dual-structured rate to differing types of investments. The regulation is now so complex, it has caused a continuing series of technical and unintentional "violations" of the regulation, and SBA is unwilling to consider change or modification.

6. Conflicts/Charges by Associate Attorney for Closing Costs - For years, SBA's regulations acknowledged the conventional practice of the SBIC's attorney charging the small business being financed for reasonable legal fees related to closing the deal.

In 1981, SBA determined this practice was a technical conflict of interest in cases where the lawyer was an associate of the SBIC, i.e. he was an officer or stockholder of the SBIC, or his firm was on retainer to the SBIC, and SBA changed the regulations to prohibit an associate/attorney being paid for such services. The industry objected to this change as being ludicrous, but to no avail. The practical result has been that many attorneys who still want to do the deals, have been forced off of SBIC Boards of Directors or out of SBIC officers positions, causing a loss of good talent to the SBIC; while the small business is still being charged the same freight by the "independent" attorney.

7. Conflicts/ Joint Financings with Associates - Many SBICs have parent or sister private venture funds, and the normal practice for years has been for both the venture fund and the SBIC to coinvest in the same deal, assuming it is otherwise qualified for an SBIC investment. These coinvestments normally take place at the initial investment, and continue through subsequent rounds of financing the small firm as it grows.

In 1981, SBA determined that such co-investments were a technical conflict of interest, and proposed a change in the rules to prohibit them. The industry strongly objected, pointing out that the parties who would be injured by the new rules would be small firms precluded from a source of financing and SBICs that would be shut out of good deals, to their detriment.

In its wisdom, SBA gave us half a loaf. The regulations now allow SBICs to coinvest with associated venture funds in the first round of financing, but not in subsequent rounds. The practical result of this nonsensical approach is that SBICs lose the opportunity to exercise what would normally be a pre-emptive right to participate in later rounds of financing of a company that has grown and could provide significant appreciation in value for the SBIC.

8. Redemptions (puts) - Redemption features in deals are an important liquidity option for all venture investment firms. For some 23 years, SBICs were able to structure their deals with redemption provisions common to all venture investment deals, i.e. on whatever basis they could negotiate with the small firm being financed.

In 1981, in an effort to "protect" small business, SBA proposed a new regulation which would have made the use of "puts" impossible. After an outcry from the industry, SBA backed off slightly, but still implemented a regulation that severely restricted the type of redemptions SBICs could employ. Under the new regulation, the price for any redemption of equity securities, options or warrants had to be predetermined by a formula based on book value or earnings of the small concern.

The result has been to severely restrict SBICs in undertaking commonly structured financings in the venture arena, and to preclude them from participation in deals syndicated by other venture firms that have conventional redemption features. In addition, the regulation prevents the implementation of common redemptions provisions which are often favorable to the small business being financed, e.g. under the current regulation, an SBIC cannot structure a preferred stock deal which would be redeemable at par.

9. Ad Hoc Policies - In addition to the specific regulations used as examples above, SBICs must continually operate in an environment of ad hoc, and often arbitrary, policy decisions made in individual cases, which are never codified into regulations or communicated to the remainder of the industry.

Conclusion - The bottom line for the SBIC industry in an environment of uncertainty, coupled with the problem of dealing with a group of unskilled bureaucrats who have little understanding of, and absolutely no experience in, the commercial world of venture capital. These problems would be solved by COSBI.

COSBI

THE CORPORATION FOR SMALL BUSINESS INVESTMENT

AN EXECUTIVE SUMMARY

January, 1988

COSBI TRANSITION COMMITTEE

David B. Jones
InterVen Partners, Inc.

Harvey Wertheim
Harvest Ventures

David D. Croll
TA Associates

David A. R. Dullum
Frontenac Capital Corp.

Peter F. McNeish
NASBIC

COSBI EXECUTIVE SUMMARY

Contents

I. Introduction

- A. What is COSBI?
- B. What we have done - fine-tuning the concept.
- C. Current status of the legislation.

II. Financial Structure

- A. Capitalization - how we find the equity.
- B. Transaction to buy the FFB portfolio.

III. Operations

- A. How we manage the corporation.
- B. How we finance SBICs - methods and costs.
- C. How we regulate SBIC business practices.
- D. Government oversight.

Appendices

1. Industry capital by segment.
2. Investment banker tranche model.
3. Default ratio chart.
4. Financial model:
    - a. Assumptions.
    - b. Pro-Forma financials.

I. INTRODUCTION

A. WHAT IS COSBI?

HISTORIC PERSPECTIVE

Since 1958, the SBIC program has been one of the most successful programs sponsored by the government. Its success is based on the time-tested business principles which drive America's free enterprise system -- private capital at risk, profit motive, market discipline and bottom-line, risk/reward realities for management.

Despite its successful track record of almost 30 years, today the SBIC program faces very serious probems. As long-term investors, SBICs need a reliable source of funds and a stable operating environment in order to plan and invest effectively.

Continued uncertainties of annual Congressional funding, changing methods of providing leverage, and restrictive allocations of scarce dollars have made the financial process unreliable. Continually changing regulatory policies, exacerbated by the government's recent attempts to terminate SBA and the SBIC program, have created an unstable operating atmosphere for SBICs which is highly detrimental to the sound conduct of their long-term investment business. These funding and regulatory problems have recently been compounded by a rapid expansion of both the industry and its level of investment activity.

Recognizing that the industry had reached a critical stage in its development, the leadership of the national trade associations for SBICs and MESBICs initiated a joint effort to design a new financial intermediary which would meet the unique needs of the SBIC and MESBIC industries and provide them with stable access to the capital markets. The proposed Corporation for Small Business Investment (COSBI) will give SBICs that facility.

BASIC STRUCTURE OF THE FACILITY

COSBI is designed to operate as a capital bank for the SBIC industry, providing SBICs and members a dependable flow of funds from capital markets at reasonable cost, together with an improved operating environment in which to conduct business.

Ownership and Management

COSBI will be a privately owned and managed, for-profit corporation. SBICs and members will invest $20 million of their private funds and purchase voting common stock in order to provide the equity capital of the corporation. COSBI will be managed by a professional management team reporting to a 15-member Board of Directors, nine of whom will be elected by the voting common stockholders. Subject to statutory limitations, the Board of Directors will set policy for the company and its operations will be carried out by staff hired by the corporation.

"Agency" Status

At the same time, the new entity will be chartered by an act of Congress and imbued with a set of special characteristics which will give COSBI federal "Agency" status. These special features, patterned after those of other government-sponsored corporations such as the Federal National Mortgage Association (FNMA) and the Student Loan Marketing Association (SLMA), include the following:

- Public directors appointed by the President. (see "Operations - How we manage the corporation")
- Congressional oversight of the corporation's activities. (see "Operations - Government oversight")
- A Treasury "backstop" which authorizes the U.S. Treasury to purchase securities of the corporation. Under the legislation the Secretary of Treasury has discretionary authority, subject to appropriation of funds by Congress, to purchase COSBI securities in an amount not to exceed $500 million.
- Exemption from securities registration.
- Exemption from state and local taxes.
- Securities of the entity are legal investments for banks and other federally-supervised financial institutions.

WHAT WE WILL ACCOMPLISH

If we succeed in having COSBI enacted into law, we will achieve several important objectives.

Stable and Affordable Funding

SBICs will gain stable and continuing access to funding in the capital markets at affordable prices. The "Agency" status of COSBI's securities, although not explicitly backed by the full faith and credit of the U.S. Government, is a symbol to investors that the U.S. Government has a vital interest in the company's finacial condition. Consequently, COSBI will be able to sell its securities at a spread slightly higher than U.S. Treasury securities of comparable maturities. COSBI, in turn, will provide financing to SBICs at attractive long-term rates.

Reliable Operating Environment

In addition, the environment in which SBICs operate their companies will materially improve. Specific standards of good business conduct will continue to be required, and abusive practices will be prohibited or restricted, both by statutory mandate and by rules established by COSBI's Board of Directors. The SBIC industry has a vested interest in assuring such abuses do not occur. However, the days of constantly changing regulations, ad hoc decisions and arbitrary actions by federal bureaucrats will be eliminated. Because COSBI will be directed by experienced SBIC professionals who have an intimate knowedge of the industry, the operating "rules of the road" will be stabilized and their application will become substantially more efficient. SBICs, as long-term investors, will have a reliable system they can depend upon.

Public Purposes

Finally, several important public purposes will be served by the creation of COSBI. Small business will be a primary beneficiary, as the flow of needed capital to small firms will materially increase. Because small business is the major job creator and product innovator in the U.S. economy, increased investments flowing through COSBI will create thousands of new jobs and bolster the development of new technologies. Over time, the new system will reduce the Federal deficit by several hundred million dollars, and new tax revenues will be produced through increased investments in the economy. In addition, the government will be streamlined by eliminating SBA's complex financial, regulatory and support apparatus now associated with the SBIC program.

B. WHAT WE HAVE DONE - FINE TUNING THE CONCEPT

LEGISLATIVE PROGRESS IN 1986

After an extensive joint-effort by NASBIC and NAIC, COSBI legislation was introduced in the U.S. House of Representatives in 1986 with bipartisan co-sponsorship from 42 members of the House Small Business Committee. Late in the Congressional session, following a series of hearings, that Committee passed the legislation unanimously. It was then incorporated into the Budget Reconciliation legislation which was passed by the U.S. House of Representatives.

While a similar COSBI bill had been introduced in the U.S. Senate, and the Senate Small Business Committee held a hearing on the bill, it did not otherwise take action on the legislation. When a different version of the Budget Reconciliation bill passed the Senate, the COSBI legislation went to a conference between the Senate and House Small Business Committees. The conferees could not reach agreement on COSBI, and it was removed from the Budget Reconciliation Act which was later signed into law.

However, the extensive efforts in the 99th Congress developed significant Congressional awareness of COSBI, helped to educate members of Congress of its importance and laid the groundwork for renewed efforts in 1987.

ISSUES OUTSTANDING AT THAT TIME

While the COSBI effort in 1986 attempted to take advantage of a small legislative window of opportunity, it was apparent that a number of issues remained outstanding with the major players in the process.

Questions From The Industry

While SBIC industry support for the COSBI concept was quite strong, lingering questions remained. Feedback from industry members reflected the need to answer a series of legitimate questions. How will COSBI be managed? How will COSBI operate? How will COSBI's financial structure work? What will SBIC financing through COSBI cost? In essence, industry members, as potential investors, were asking for a detailed business plan for COSBI.

In addition, several questions were raised regarding the capital contributions formula imbodied in the original version of COSBI, i.e. whether it provided an equitable distribution of the financial burden to capitalize COSBI.

Objections From the Administration

The Administration made it clear from the outset that they opposed COSBI. Their opposition was at two levels: ideological opposition and objection to specifics. The agencies involved included OMB, Treasury and SBA.

As a matter of ideology, the Administration took a position opposed to any form of intervention by the Federal government in the credit markets, including government sponsored enterprises. Consequently, not only was the Administration fundamentally opposed to COSBI, they also proposed stripping FNMA and other sponsored "agencies" of their implicit federal support.

In terms of specifics, Treasury opposed the sale of the FFB-held SBIC debentures on a recourse basis, and raised a series of issues related to the government's financial exposure under COSBI. SBA objected to the circumscription of its regulatory authority, and raised similar financial issues.

Changes in Congress

The House - As indicated previously, COSBI had very strong bipartisan support from the House Small Business Committee in the 99th Congress. While the nucleus of that support remains, there has been a material change in the makeup of the House Committee. Congressman John LaFalce (D-NY) is the new Chairman, and he brings a new staff and his own agenda to the Committee leadership. Chairman LaFalce has indicated that COSBI will be a priority legislative initiative for the Committee. Congressman Joseph McDade (R-PA), a strong supporter of COSBI, remains the Ranking Minority Member of the Committee.

The Senate - A COSBI bill was introduced in the Senate in 1986, co-sponsored by Senator Lowell Weicker (R-CT), who was then Chairman of the Committee, and Senator Dale Bumpers (D-AR), who was then Ranking Minority Member. Now the Senate Committee has also undergone a change in leadership as a result of the Democrats taking control of the Senate. Senator Bumpers is the [illegible] Chairman; and he has said that COSBI will be a top legislative priority for the Committee this Congress. Senator Weicker remains influential as the Ranking Minority Member.

HOW WE'VE ADDRESSED THE ISSUES

Recognizing that COSBI's success was dependent upon the resolution of these issues, the COSBI Transition Team initiated the following actions.

Industry Meetings

During the fourth quarter of 1986 and the first quarter of 1987 a series of meetings were held with various segments of the industry to identify and resolve specific issues related to COSBI. The formula for SBIC capital contributions to COSBI was a major concern of many companies. This issue has now been resolved. (See "Capitalization - how we find the equity") The remaining financial and operational questions have also been addressed. This process of industry involvement culminated in the endorsement of a definitive plan of operations and financial model for COSBI by NASBIC's Board of Governors in March, 1987.

Investment Bankers

As part of this process, NASBIC enlisted the services of a group of investment banking firms. Working as a syndicate, Citicorp Investment Bank, the First Boston Corp., Goldman-Sachs & Co. and Paine Webber Group, Inc. provided expert advice on COSBI's "Agency" status; valuation, pricing and financing of the FFB-held portfolio of SBIC debentures; and COSBI's long-term financial structure.

Arthur Andersen & Co.

Arthur Andersen & Co. established a special team to work with NASBIC on COSBI's business plan and financial models. Working in conjunction with the investment banking group and responding to a stream of changing financial and transactional assumptions, the Arthur Andersen team has provided expert advice on COSBI's financial structure and has produced well in excess of 100 models of COSBI pro forma financial statements.

Congress

Over the past nine months countless meetings have been held with members of the House and Senate Small Business Committees and their staffs. Every concept in the COSBI legislation and every detail in the bill relating to oversight of COSBI, regulatory structure, purchase of the FFB portfolio, capitalization and management of the corporation has been thoroughly analyzed, negotiated and re-negotiated.

The Administration

A series of meetings have been held with senior Administration officials in an effort to neutralize their opposition to COSBI or to support the legislation.

C. CURRENT STATUS OF THE LEGISLATION IN THE 100th CONGRESS

INTRODUCTION OF H.R. 3392 IN THE HOUSE

A new version of the COSBI legislation was introduced in the U.S. House of Representatives on October 1, 1987. The bill (H.R. 3392) had the bipartisan sponsorship of Congressman John LaFalce (D-NY), Chairman of the House Small Business Committee, and Congressman Joseph McDade (R-PA), Ranking Minority Member of the Committee. Committee Chairman LaFalce has indicated that the COSBI legislation is a priority item on the Committee's agenda.

Subcommittee hearings on the legislation were held in November and December of 1987. Following additional hearings, full Committee consideration and mark-up of the bill is expected before mid-March, 1988.

INTRODUCTION OF S. 1929 IN THE SENATE

A similar version of the COSBI bill was introduced in the U.S. Senate (S. 1929) on December 8, 1987 by Senator Dale Bumpers (D-AR), Chairman of the Senate Small Business Committee, and Senator Lowell Weicker, Ranking Minority Member of the Committee. Senate hearings are scheduled for February and March.

REMAINING HURDLES

While introduction of COSBI in the House and Senate is a major step forward, several hurdles must be overcome before the bill is enacted into law. These include:

- A very crowded election year legislative calendar and likely adjournment by Congress in October, 1988.
- Resolution of outstanding issues in the bills.
- Referral of the bills to other Committees of the Congress which may claim jurisdiction because of securities, tax, banking and government operations features in the legislation.
- Opposition by the Administration.

EFFECTIVE DATE OF COSBI

Our objective is to have the COSBI legislation passed and signed into law by late Spring of 1988, with COSBI in business in the Fall of 1988. The legislation provides for the formation, within 60 days of enactment, of an interim Board of Directors which will organize the Corporation and initiate the stock offering to raise COSBI's initial capital. SBICs owning stock in COSBI will then elect a permanant Board, who will bring the corporation to full operational status, purchase the FFB portfolio and begin operations.

II. FINANCIAL STRUCTURE

A. CAPITALIZATION - HOW WE FIND THE EQUITY

INITIAL CAPITALIZATION - STOCK OFFERING TO SBICs

Following enactment of COSBI, the corporation will undertake a common stock offering to raise a minimum of $20 million. Each SBIC will be offered the right to purchase a minimum number of shares of common stock on the following formula basis:

- One percent (1%) of the SBIC's private capital, plus
- One percent (1%) of the principal balance of the SBIC's outstanding SBA-guaranteed debentures.

The COSBI Board is authorized to exempt any debentures having maturities of three months or less.

(See Appendix 1 for an analysis of capital contributions by industry segment.)

SBIC PARTICIPATION

Any licensed SBIC in good standing with SBA will automatically qualify with COSBI and continue as an operating SBIC if it makes the required capital contribution. SBICs which elect not to qualify and do not make capital contributions will liquidate or convert to non-SBIC status under SBA regulations administered by COSBI under an agreement with SBA.

ADDITIONAL CAPITAL

COSBI will have access to additional capital based on the volume of funding it provides to SBICs, growth of the SBIC industry and the corporation's performance over time.

COSBI's Board will have authority to require SBICs that secure leverage from COSBI on a continuing basis to make a capital contribution not to exceed one percent (1%) of the amount of that leverage.

Newly licensed SBICs will be required to make a capital contribution equal to one percent (1%) of their private capital, and the Board will have authority to require operating SBICs to make supplemental capital contributions not to exceed one percent (1%) of any increases in their private capital.

USE OF PROCEEDS

COSBI's capital will provide an equity base for borrowing activities and working capital for general corporate purposes.

SBIC Investment Example

Assumptions:

- SBIC with $5.0 million private capital and $5.0 million debentures.
- The SBIC does not increase its capital and does not make further purchases of COSBI stock.
- The government exercises the warrants in the 10th year. On a primary basis the warrants equal 30% ownership. In year 10, after dilution, the warrants equal 15% ownership.
- Each SBIC purchases its common stock based on 1% of capital and 1% of outstanding debentures.

SBIC Investment:

Capital	- 1% x $5.0 million =	$ 50,000
Debentures	- 1% x $5.0 million =	50,000
Total investment		$100,000

- The SBIC has 0.5% ownership at the time of COSBI' formation.
- In year 10, after dilution, the SBIC's ownership is equal to approximately 0.215%.

Value of the SBIC Investment:

- Aggregate equity value of COSBI in year 10 = $90 million.
- The SBIC's 0.215% ownership = $193,500.

Therefore, an SBIC which invests $100,000 at the time of COSBI's formation will double its investment by the 10th year.

B. TRANSACTION TO BUY THE FFB PORTFOLIO

FORM - SALE WITH RECOURSE

Under the legislation, COSBI's purchase of the SBIC debenture portfolio held by the FFB will be on a "recourse" basis. The government guaranty will remain on the debentures following their purchase by COSBI, and in the event of default SBA will repurchase the debenture in an amount equal to the outstanding principal balance plus any accrued interest.

TIMING

H.R. 3392 specifies September 30, 1988 as the FFB portfolio sale date; while S. 1929 says "no later than October 1, 1988."

HOW WE'VE VALUED

The investment banking syndicate noted earlier made an independent valuation of the FFB portfolio to be purchased by COSBI, on both a non-recourse and recourse basis.

Their non-recourse valuation employed the same sophisticated analysis currently applied to the sale of "securitized" or asset-backed securities in the bond markets. Using a set of assumptions relating to the risk of defaults, losses and net realized recoveries, their model divided the total portfolio into a series of tranches and valued the projected cash flows of those tranches over the life of the portfolio.

(See Appendix 2 - "Investment banker tranche model.")

In determining the price that an independent third-party investor would pay for the FFB portfolio on a non-recourse basis, the investment bankers used the following assumptions derived from historical SBIC default and loss rate experience.

- the outstanding principal balance as of September 30, 1988 would be $707,393,700.
- the imputed default rate would be 30% plus a risk cushion.
- the net realized recovery rate after expenses would be 10%, and
- the effective net realized loss rate would be 27%.

(See Appendix 3 - "Default ratio chart.")

Based on those assumptions, the investment bankers concluded that the FFB portfolio, if sold on a non-recourse basis, had a market value of $527,900,000.

For a recourse sale, based on interest rates in effect at that time, the investment bankers valued the portfolio at 102% of face value, or $721,540,860.

WHAT WE PAY - HOW THE DEAL IS PRICED

COSBI will pay full value for the FFB Portfolio, based on a recourse sale.

The legislation establishes a market value floor for the purchase price. The bill provides that COSBI shall pay "not less than $720,000,000" for the FFB portfolio, which is the estimated market value of those securities if sold to an independent third-party investor on a with-recourse basis.

The bill also established a specific procedure for determining the final purchase price. Within ten days after COSBI gives notice that it is prepared to do business, the Secretary of Treasury is required to propose a purchase price for the FFB portfolio. If acceptable to COSBI, that becomes the final purchase price. If unacceptable to COSBI, the Corporation and the Secretary are each required to select an investment advisor, who select a third investment advisor. The price agreed to by two of the three investment advisors becomes the final purchase price, subject to necessary adjustments caused by market rate changes between the time the price is established and the transaction is actually closed.

HOW WE PAY - STRUCTURE OF THE DEAL

Under the legislation, the transaction is structured so that COSBI's purchase will involve a combination of cash, preferred stock and detachable warrants, as follows:

Cash

COSBI will pay cash in an amount equal to the recourse value of the portfolio at the time of the transaction. Based on the interest rate assumptions used in the pro forma models, COSBI would pay $527,900,000 in cash. The amount of cash paid by COSBI will be adjusted at the time of the transaction to reflect the acual recourse value of the portfolio based on interest rates in effect at that time.

Preferred Stock

COSBI will issue $200 million of non-voting preferred stock to the government. No dividends are payable for the first two years of COSBI's operations. Thereafter, the preferred will provide a 5% non-cumulative dividend, but such dividends can only be paid each year from realized, net after-tax earnings in that year in excess $2,000,000.

Warrants

The government will receive detachable, 15-year warrants to purchase a non-voting common stock interest in COSBI, in an amount equivalent to approximately 30% ownership on a primary basis.

The exercise price is computed on a "primary basis," i.e., the exercise price will be the same price per share paid by COSBI stockholders at the time of COSBI's formation, plus a 50% premium.

The ownership interest is also computed on a "primary basis," i.e. when exercised, the government will be entitled to purchase the same amount of non-voting common shares it would have purchased if the warrants had been exercised at the time of COSBI's formation. The warrants do not have anti-dilution protection.

The government's actual percentage of ownership will be determined by dividing the amount of preferred stock by the actual purchase price of the portfolio at the time of closing. Based on the assumptions used in the pro forma model, the government would acquire an ownership interest, in the form of non-voting common, of 27.5% on a primary basis ($200 million divided by $727.9 million).

If the government exercises the warrants, it can either use cash or convert an equal amount of its preferred stock to consumate the transaction. The non-voting stock it acquires can be sold to any party; however, the stock would convert to voting common if sold to an active SBIC.

HOW WE FINANCE THE PURCHASE

Structure

COSBI will finance its purchase of the FFB portfolio through the issuance of debt securities in the capital markets. The pro forma financial model assumes COSBI's debt securities will be issued on a "matched book" basis, allowing COSBI to retire its debt as debentures are paid off.

Cost

Because of COSBI's status as a government-sponsored corporation, its debt securities will have market acceptance as federal "Agency" securities. This category of investments is well known to informed investors, and will command a rate of interest at a modest spread over Treasury securities of comparable maturities. The pro forma financials assume COSBI will be able to obtain pricing at a 65 basis point spread.

Proceeds

$150 million of the cash proceeds from the sale will be devoted to the asset base of the MESBIC Trust. The balance of the purchase price will go to the U.S. Treasury.

FINANCIAL SUMMARY

Income Statement Highlights
($ 000)

	Yr. 1	Yr. 2	Yr. 3	Yr. 4	Yr. 5	Yr. 6	Yr. 7	Yr. 8	Yr. 9	Yr.10
Interest income on purchased portfolio	75,800	66,700	54,800	43,700	31,200	20,200	13,500	1,700	--	--
Interest spread on new SBIC leverage	1,000	3,200	5,800	9,000	12,600	16,600	20,300	24,000	27,500	31,000
Gross port. income	76,800	69,900	60,600	52,700	43,800	36,800	33,800	25,700	27,500	31,000
Portfolio expenses, incl. interest, loss reserve, etc.	62,200	57,900	51,300	46,500	42,400	31,600	24,700	16,100	14,100	14,500
Net port. income	14,600	12,000	9,300	6,200	1,400	5,200	9,100	9,600	13,400	16,500
G & A	3,200	4,400	4,600	4,700	5,000	5,000	5,000	5,000	5,000	5,000
Other program exp's.	200	600	500	600	600	600	600	700	700	700
Total oper. exp's.	3,400	5,000	5,100	5,300	5,600	5,600	5,600	5,700	5,700	5,700
Net income before taxes	11,200	7,000	4,200	900	(4,200)	(400)	3,500	3,900	7,700	10,800
Fed. inc. tax	3,800	2,400	1,400	290	1,400	130	1,180	1,300	2,600	3,700
NET INCOME	7,400	4,600	2,800	610	(2,800)	(270)	2,320	2,600	5,100	7,100

III. OPERATIONS

A. HOW WE MANAGE THE CORPORATION

Board of Directors

After the initial $20 million has been raised from the common stock offering, COSBI will be managed by a fifteen member Board of Directors. The SBICs holding common stock will elect nine members of the Board. Each share of common will be entitled to one vote with cumulative voting rights at elections of directors. One director will be selected by the trustees of the MESBIC Trust; and the remaining five directors will be appointed by the President of the United States. Under H.R. 3392, one of the five Presidential appointees must be a representive of small business and one must be an owner or operator of a small business. S. 1929 differs slightly, requiring one Presidential appointee to be an owner or operator of a small business and one to be the SBA Administrator.

The Board of Directors will have senior management responsibility for COSBI and will determine the corporation's general business, investment and operating policies. The elected members of COSBI's Board will be highly qualified SBIC executives who, as leaders in the industry, will provide balanced representation for all SBICs.

Operational Structure

COSBI will be operated as a streamlined, efficient and cost-conscious business organization.

While COSBI's organizational structure will be established by the Board of Directors, it is anticipated that the structure will be similar in concept to SBA's investment division, with certain additions to accomodate COSBI's operations as a free-standing financial institution. Functional units would include program operations, finance, servicing, administrative support and executive supervision. In addition, a regulatory compliance and investigations function would either be administered directly by COSBI, or provided under contract by outside service firms.

COSBI's Board will also establish internal systems to assure the sound operation of a well managed financial institution. These will include audit and finance committees of the Board, internal finance and budgetary control systems, and automated accounting and data systems.

The Board will also appoint, prescribe the functions, powers and duties of, and establish compensation for the executive officers who will manage the day-to-day operations of the corporation. The executives selected to manage the corporation will be highly qualified individuals who are familiar with the SBIC industry and have financial institution managerial experience.

B. HOW WE FINANCE SBICs - METHODS AND COSTS

A major objective of COSBI is to provide stable and continued access to capital for SBICs. To meet this objective, COSBI will serve as a source, secondary market and warehousing facility for loans and investments in SBICs, and will provide liquidity for loans and investments in small business.

Funding SBICs

COSBI's principal activity will be the purchase of securities from SBICs which meet the corporation's eligibility requirements. COSBI's Board will establish a basic leverage eligibility policy for every SBIC that meets a uniformly applied set of financial standards, regardless of the SBIC's size or investment policy.

Initially, COSBI will continue to finance SBICs through the purchase of medium and long-term, fixed rate securities. However, COSBI will be able to finance SBICs through a variety of more sophisticated instruments which could more appropriately match the specific needs of SBICs. Once COSBI's positive performance record and sound financial condition have been firmly established, and its securities have gained acceptance in the capital markets, COSBI will broaden its program options and develop customized financial products to meet industry needs.

Limitations on Leverage

Under the legislation, the 4:1 leverage cap is replaced by a new rule under which leverage to any single SBIC is limited to 10% of COSBI's assets. COSBI's Board is also required to establish leverage limitations for multiple SBICs under common control.

What It Will Cost

COSBI's federal "Agency" status will enable it to raise funds at a rate spread slightly above comparable U.S. Treasurys; estimated by COSBI's investment banking advisors to be about 65 basis points. The financial model (Appendix #4) assumes that COSBI will price leverage at a 1% spread over its cost of funds. (Note - The actual interest spread COSBI charges on loans to SBICs will be determined by the Board, and could be lower.) Using this assumption, an SBIC's effective cost of funds would be comparable, though slightly higher than the current leverage system, as indicated below:

Item	9/87 funding	COSBI
10-year Treasury	9.47	9.47
Market spread	.88	.65
Nominal Rate	10.35	10.12
Underwriter's fee (discounted)	.10	--
SBA User Fee (discounted)	.20	--
COSBI spread	--	1.00
Effective SBIC Cost	10.65	11.12

C. HOW WE REGULATE SBIC BUSINESS PRACTICES

Qualifications to do Business

Existing SBICs in good standing are automatically qualified to do business with COSBI so long as they purchase the required amount of COSBI voting common stock. For new SBICs, the legislation requires that applicants have: a minimum capital of $1 million; owners and managers with sound business reputations and character; and the probability of successfully operating an SBIC, including adequate profitability and financial soundness. The bills also direct COSBI to establish additional standards as appropriate.

Mechanism for Regulation of SBICs

The bill provides that SBICs are required to enter into a contract with COSBI, under which they agree to abide by COSBI's rules governing SBIC business practices.

Major Regulations

The major areas of regulatory restriction on SBIC business practices are enumerated in the statute, and COSBI's Board must issue definitive rules in these areas. Under S. 1929, these rules may be approved by a majority of the Board; under H.R. 3392, such rules will require approval by a majority of the public directors on the Board. These major restricted practices are as follows:

- Prohibition against conflict of interest transactions.
- Restriction of investments to only qualified small business. (Note - The legislation would increase the size standard from $6.0 to $8.0 million net worth and from $2.0 to $2.5 million average net income.)
- Prohibition against control of small firms.
- Required diversification of investment risk, i.e. an SBIC can invest no more than 20% of its private capital in any one small business.
- Prohibition against investments in passive businesses, foreign companies, re-lending activities, or the acquisition of real estate, and
- Prohibition against engaging in unlawful or non-SBIC activities (i.e., operating other types of businesses).

Other Regulations

Rules governing all other aspects of an SBIC's business operations will be established by a majority of COSBI's Board.

COSBI Oversight, Audits and Investigations

The legislation requires a biannual compliance audit of each SBIC by COSBI or an independent CPA under contract to COSBI. The statute mandates that COSBI exercise due diligence in the oversight, auditing and investigation of SBICs. It is expected that COSBI will have its own expert staff to carry out these functions, supplemented by independent CPA audits of each SBIC.

SBA Inspector General Audits of SBICs

H.R. 3392 provides that while an individual SBIC has an SBA-guaranteed debenture outstanding, the SBA Inspector General is empowered to audit that SBIC if: (1) he has "reasonable cause" to believe that the SBIC has violated one of the major rules (noted above); or (2) he has "probable cause" to believe that the SBIC has committed civil fraud or has violated a Federal criminal statute.

S. 1929 differs in that it would authorize the SBA Inspector General, if he makes the proper "for cause" showing, to make such audits of any SBICs, even if the SBIC does not have an SBA-guaranteed debenture outstanding.

Enforcement of the Rules

The statute directs COSBI to adopt measures to assure compliance with its rules, and provides COSBI with several specific enforcement powers, namely:

- Termination or suspension of agreements between COSBI and the SBIC,
- Termination of an SBIC's qualification to do business with COSBI,
- Assessment of penalties against an SBIC or its officer or directors, or
- In appropriate cases, referral of violations to SBA for investigation, or referral to the U.S. Attorney.

In addition, COSBI will have access to all appropriate civil remedies where an SBIC has breached its contractual agreement with the corporation; including acceleration of debt in cases of default, actions to enforce contractual covenants and initiation of litigation against the SBIC.

D. GOVERNMENT OVERSIGHT OF COSBI

OVERSIGHT OF COSBI's FINANCIAL PERFORMANCE

Restriction on COSBI Debt

The statute limits COSBI's issuance of debt by setting a maximum debt to capital ratio of not more than 15 to 1, which is the same as the statutory debt restriction on FNMA.

Treasury Approval of COSBI's Issuance of Securities

All obligations issued by COSBI must be approved by the Secretary of the Treasury. This conforms with Treasury's authority to control the issuance of securities by other federal "Agencies."

Annual Audit

The statute requires that COSBI be audited each year by an independent CPA or Treasury. In addition, COSBI is subject to audit by GAO at any time at the request of either Small Business Committee of Congress.

Government Access to COSBI's Books and Records

The Small Business Committees, GAO, Treasury, SBA and SBA's Inspector General have access to all of COSBI's financial books and records.

OVERSIGHT OF COSBI's REGULATORY PERFORMANCE

SBA Oversight

Under H.R. 3392, SBA does not have rulemaking authority over COSBI or the operations of individual SBICs.

However, the bill does give SBA review authority over all of COSBI's operations, including the standards the corporation sets for SBICs to do business with COSBI, the rules COSBI establishes for SBIC business practices and "such other matters as the Administration deems appropriate." In addition, COSBI is required "to make such reports the Administration deems desirable."

Under S. 1929, SBA would be given authority to make such rules and regulations as necessary to ensure that the public purposes of the Act are accomplished. SBA's rules would govern COSBI's operations (and implicitly the operations of SBICs). Any rule promulgated by SBA would have to be made on the record, and before going into effect it would be subject to a hearing process specified in the Administrative Procedures Act.

SBA is required to make an annual report to Congress and the President on COSBI's operations, including an assessment of COSBI's regulatory activities.

Congressional Oversight

The Small Business Committees of Congress and GAO have full authority to review COSBI's regulatory operations at any time.

Access to COSBI's Books and Records

The Small Business Committees, GAO, SBA and the SBA Inspector General have access to all of COSBI's books and records.

In addition, GAO is required to submit a report to Congress by January 31, 1993, on how well COSBI has achieved the purposes of the Act, including an assessment of COSBI's regulatory performance.

Appendix 1

Capital by Industry Segment

(Based on SBA data from 468s filed through 9/29/86)

(dollars in millions)

Size	#	Cap.	Lvg	2% Cap.	1% Cap. + 1% Lvg.
Under $1M	101	$ 58.9	$ 75.8	$ 1.178	$ 1.347
$1-5 M	174	339.9	367.4	6.798	7.073
$5-10 M	32	208.5	265.2	4.170	4.737
Over $10 M	28	605.3	279.3	12.106	8.846
SBIC Total	335	$ 1,212.6	$ 987.7	$ 24.252	$ 22.003
MESBICs	132	$ 148.4	$ 88.0*	$ 2.968	$ 2.364
TOTAL	467	$ 1,361.0	$ 1,075.7	$ 27.220	$ 24.367

(* MESBIC debentures only)

APPENDIX 2

CORPORATION FOR SMALL BUSINESS INVESTMENT
Valuation of FFB Portfolio
Sample Cash Flows for a Senior/Subordinated Pass-Through
($ in Millions)

24-Jul-87

Qtrly Pds	Loan Balance (A)	Sched Princ (B)	Princ Default (C)	Princ Rcv'd (D)	Interest Rcv'd (E)	Default Recovery (F)	Total Cash (G)	Service Fee (H)	Excess Service (I)	A Class Balance (J)	A Class Interest (K)	A Class Princ (L)	B Class Balance (M)	B Class Interest (N)	B Class Princ (O)	B Class Recovery (P)
0	707.395									424.436			282.957			
1	676.918	16.660	14.148	16.327	19.952	0.000	36.278	1.326	2.676	414.640	9.815	9.796	276.426	6.543	6.531	12.667
2	652.907	10.280	14.148	9.864	19.075	0.000	28.938	1.269	2.559	408.721	9.589	5.918	272.481	6.392	3.946	9.604
3	632.404	6.770	14.148	6.355	18.383	2.077	26.815	1.224	2.448	396.420	9.452	12.302	264.280	6.301	8.201	1.370
4	609.363	9.690	14.148	8.893	17.793	2.077	28.763	1.186	2.390	382.595	9.167	13.824	255.063	6.111	9.216	2.195
5	581.446	15.360	14.148	13.769	17.130	2.077	32.976	1.143	2.303	365.845	8.848	16.750	243.897	5.898	11.167	3.932
6	545.214	25.250	14.148	22.084	16.327	2.077	40.487	1.090	2.198	344.106	8.460	21.739	229.404	5.640	14.493	7.000
7	508.286	26.740	14.148	22.780	15.284	2.077	40.141	1.022	2.061	321.949	7.957	22.157	214.633	5.305	14.771	6.963
8	449.176	54.290	14.148	44.963	14.221	2.077	61.261	0.953	1.921	286.483	7.445	35.466	190.989	4.963	23.644	15.475
9	424.708	12.866	14.148	10.320	12.520	2.077	24.917	0.842	1.698	271.802	6.625	14.681	181.201	4.417	9.787	1.071
10	397.262	17.150	14.148	13.298	11.816	2.077	27.191	0.796	1.605	255.335	6.285	16.468	170.223	4.190	10.978	2.036
11	376.013	9.497	14.148	7.101	11.026	2.077	20.204	0.745	1.502	243.282	5.905	12.053	162.188	3.936	8.035	0.000
12	339.413	31.199	14.148	22.452	10.414	2.077	34.943	0.705	1.421	220.625	5.626	22.657	147.083	3.751	15.106	4.534
13	316.327	12.960	14.148	8.938	9.361	2.077	20.376	0.636	1.283	207.271	5.102	13.354	138.181	3.401	8.903	0.000
14	280.123	33.480	14.148	22.057	8.697	2.077	32.830	0.593	1.196	185.051	4.793	22.220	123.367	3.195	14.813	4.028
15	255.059	17.450	14.148	10.915	7.655	2.077	20.647	0.525	1.059	170.268	4.279	14.783	113.512	2.853	9.856	0.000
16	224.362	28.010	14.148	16.549	6.933	2.077	25.559	0.478	0.964	151.595	3.937	18.673	101.063	2.625	12.448	1.507
17	195.335	26.800	14.148	14.879	6.050	2.077	23.007	0.421	0.848	134.178	3.506	17.417	89.452	2.337	11.611	0.816
18	168.964	23.883	14.148	12.222	5.215	2.077	19.514	0.366	0.738	118.872	3.103	15.306	79.248	2.069	10.204	0.000
19	141.584	28.125	14.148	13.232	4.456	2.077	19.765	0.317	0.639	102.812	2.749	16.060	68.541	1.833	10.707	0.000
20	114.228	31.190	14.148	13.208	3.668	2.077	18.952	0.265	0.535	87.036	2.378	15.776	58.025	1.585	10.516	0.000
21	104.721	22.450	0.000	9.507	3.287	2.077	14.871	0.214	0.432	74.825	2.013	12.212	49.884	1.342	8.142	0.000
22	96.447	19.539	0.000	8.274	3.014	2.077	13.365	0.196	0.396	63.783	1.730	11.042	42.522	1.154	7.362	0.000
23	89.614	16.135	0.000	6.833	2.776	0.000	9.608	0.181	0.365	56.195	1.475	7.588	37.463	0.983	5.059	0.000
24	85.905	8.760	0.000	3.710	2.579	0.000	6.289	0.168	0.339	51.712	1.300	4.482	34.475	0.866	2.988	0.000
25	71.041	35.100	0.000	14.864	2.472	0.000	17.336	0.161	0.325	42.625	1.196	9.088	28.416	0.797	6.059	6.567
26	59.661	26.876	0.000	11.380	2.045	0.000	13.425	0.133	0.269	35.796	0.986	6.828	23.864	0.657	4.552	5.209
27	42.773	39.880	0.000	16.888	1.717	0.000	18.605	0.112	0.226	25.664	0.828	10.133	17.109	0.552	6.755	7.307
28	21.811	49.500	0.000	20.962	1.231	0.000	22.193	0.080	0.162	13.087	0.593	12.577	8.724	0.396	8.385	8.780
29	13.670	19.225	0.000	8.141	0.628	0.000	8.769	0.041	0.082	8.202	0.303	4.885	5.468	0.202	3.256	3.458
30	0.000	32.280	0.000	13.670	0.393	0.000	14.063	0.026	0.052	0.000	0.190	8.202	0.000	0.126	5.468	5.594
Total		707.393	282.957	424.436	256.118	41.534	722.088	17.216	34.708		135.633	424.436		90.422	282.957	110.094

Present Value =
$ 25.7 MM

Present Value =
$ 423.6 MM

Present Value =
$ 78.5 MM

Total = $ 527.9 MM

KEY ASSUMPTIONS

Subordination Level:	40%
Default Rate:	40%
Default Period:	5 Years
Recovery:	6 months after default
Severity of Loss:	90%
PV Rate for A Class(5 yr + 125 bp):	9.21%
PV Rate for B Class(5 yr + 350 bp):	11.46%
PV Rate for Excess Servicing:	14%
Servicing Fee:	0.75%
Transaction & Ongoing Expenses:	$ 0

PRINCIPAL AMOUNT OF DEBENTURES ACCELERATED AND PAID BY SBA FOR SEMI-ANNUAL PERIODS SINCE ISSUANCE

AS OF JUNE 30, 1987*

(Dollars in thousands)

Origination Period**	Principal Amount of Debentures Issued	Number of Debentures Issued	SBICs Participating	Principal Amount of Debentures Accelerated and Paid in the Semi-annual Period Since Origination Period																				Total
				1***	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	
1975 I	$ 28,965	28	25	$ —	$ —	$ —	$ —	$ 150	$ —	$ —	$ 300	$ —	$ —	$ —	$ —	$ 300	$ 600	$ —	$ —	$ 590	$ 1,500	$ 600	$ 990	$ 5,030
1975 II	11,990	25	24	—	—	—	—	—	—	—	—	—	500	—	300	—	—	200	—	500	530	—	—	2,030
1976 I	9,280	12	11	—	—	—	—	—	—	—	—	—	—	—	—	—	—	610	—	—	1,000	—	—	1,610
1976 II	35,835	48	43	—	—	—	—	600	—	—	1,400	2,200	475	1,100	400	500	570	1,850	2,400	500	—	150	1,500	13,645
1977 I	40,330	40	37	—	—	300	—	650	—	500	1,250	2,000	—	—	—	—	3,500	—	1,000	2,000	600	—	1,900	13,700
1977 II	26,300	35	33	—	120	—	—	—	—	450	—	2,690	500	700	—	—	—	720	1,250	—	440	1,000		7,870
1978 I	45,354	44	40	—	—	1,950	—	—	200	—	6,690	—	—	790	—	—	1,000	—	820	500	2,000			13,950
1978 II	24,420	29	25	—	1,990	—	275	900	—	2,540	—	2,000	—	—	—	1,000	—	300	—	500				9,505
1979 I	26,655	33	32	—	—	700	250	—	400	—	1,000	—	1,250	—	—	2,000	—	1,250	3,350					10,200
1979 II	25,915	28	22	—	—	3,400	—	500	—	2,500	1,400	—	—	1,000	—	1,500	1,000	400						11,700
1980 I	24,445	27	24	—	600	—	—	—	500	1,500	500	—	1,500	—	—	1,825	1,000							7,425
1980 II	65,256	58	53	—	—	—	130	3,000	—	—	—	—	1,900	250	500	2,400								8,180
1981 I	36,197	31	28	—	—	—	2,000	1,500	—	—	—	5,500	—	500	1,250									10,750
1981 II	55,099	61	47	—	—	2,000	1,500	1,000	—	—	540	1,600	6,500	4,000										17,140
1982 I	37,320	48	37	—	—	—	300	—	—	4,258	—	2,790	2,500											9,848
1982 II	47,915	50	43	—	—	—	—	—	525	1,500	3,500	5,500												11,025
1983 I	61,728	46	40	—	—	—	—	—	500	3,750	7,500													11,750
1983 II	62,290	51	42	—	—	—	658	—	7,000	5,000														12,658
1984 I	46,674	35	31	—	—	200	—	600	1,500															2,300
1984 II	49,760	32	29	—	2,000	—	3,500	—																5,500
1985 I	76,754	49	40	—	—	2,000	2,000																	4,000
1985 II	71,835	57	50	—	2,110	—																		2,110
1986 I	31,280	25	25	—	2,250																			2,250
1986 II	67,190	36	36	—																				0
1987 I	67,100	35	35																					0
Total	$1,075,583	963	†	$ 0	$ 9,070	$10,550	$10,613	$ 8,900	$10,625	$21,998	$24,080	$24,280	$15,125	$ 8,340	$ 2,450	$ 9,525	$ 7,670	$ 5,330	$ 8,820	$ 4,590	$ 6,070	$ 1,750	$ 4,390	$194,176

Future Semi-annual Periods

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* Includes only SBIC debentures with 10-year maturities.

** The debentures were issued monthly but were aggregated into semi-annual periods for this table.

*** The first semi-annual period also includes any debentures accelerated and paid during an origination period.

† An SBIC may have issued debentures in more than one origination period. The total number of SBICs participating in the periods shown was 300.

Appendix 4a.

Assumptions for COSBI Financial Model

- **Computer model - 15 year presentation**
  - income statement
  - balance sheet
  - cash flow statement
- **Purchase of FFB portfolio**
  - outstanding principal balance as of September 30, 1988 = $707,393,700
  - investment bankers' estimate of market value on a non-recourse basis = $527,900,000 (75%)
    - investment bankers have assumed that a non-recourse third-party investor would impute a 30% default rate plus a cushion; a 10% net realized recovery rate after expenses; and a 27% net realized loss rate
  - investment bankers' estimate of market value on a recourse basis = $721,540,860 (102%)
  - debt financed purchase; COSBI borrowing at "Agency" rate
- **Capital**
  - initial industry investment of $20 million
  - formula - 1% of capital + 1% of outstanding leverage
  - 1% of private capital of new SBICs - new SBICs assumed at 20/year with average capital of $3 million
  - 1% of increases in private capital of SBICs
- **Growth of COSBI's portfolio of new loans**
  - 20 new SBICs/year
  - $200 million of new loans in first year
  - 20% annual increase in loan levels for years 2-5
  - loan levels held constant for years 6-15
- **Income/loss applicable to new loans booked by COSBI**
  - 1% spread on average new loans, financed 100%
  - 20% defaults and 60% recoveries
  - 8% loss rate
- **Fees**
  - Licensing fee - $5,000/new SBIC
  - Examination fees - avg. $5,000/SBIC; considered a "wash" as equivalent amount of expenses are factored in
- **Program and corporate costs/expenses**
  - annual operating costs approx. $5 million
  - organization similar to SBA structure
  - total staff approx. 40-50, including finance, operations, servicing, audit and compliance, admin., legal, etc.
- **Summary of 15 year results**
  - positive cash flow all 15 years
  - positive capital and retained earnings growth

APPENDIX 4b

COSBI

RECOURSE - PREFERRED STOCK WITH DIVIDEND
$200,000,000 new loan base
increasing 20% first five years

	Initial	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
BALANCE SHEET							
ASSETS:							
Old portfolio	707,393,700	634,220,120	520,614,540	428,672,960	321,899,380	202,477,800	155,518,800
Premium	14,147,160	10,834,455	7,771,239	5,125,756	2,887,358	1,190,362	74,210
New loans to SBIC's	0	200,000,000	440,000,000	728,000.000	1,073,600,000	1,488,320,000	1,903,040,000
	721,540,860	845,054,575	968,385,779	1,161,798,716	1,398,386,738	1,691,988,162	2,058,633,010
Allowance for loan losses	0	<16,000,000>	<35,200,000>	<58,240,000>	<85,888,000>	<119,065,600>	<152,243,200>
Net loan portfolio	721,540,860	829,054,575	933,185,779	1,103,558,716	1,312,498,738	1,572,922,562	1,906,389,810
Cash and short term investments	24,859,140	54,993,762	92,055,577	143,999,040	203,674,803	278,026,793	288,582,151
Deferred taxes	0	5,440,000	11,968,000	19,801,600	26,481,920	31,778,304	33,157,858
Furniture, fixtures and computer equip.	1,500,000	1,500,000	1,600,000	1,700,000	1,800,000	1,900,000	2,000,000
Accumulated depreciation	0	<150,000>	<310,000>	<480,000>	<660,000>	<850,000>	<1,050,000>
	26,359,140	61,783,762	105,313,577	165,020,640	231,296,723	310,855,097	322,690,039
Total Assets	747,900,000	890,838,337	1,038,499,356	1,268,579,356	1,543,795,461	1,883,777,659	2,229,079,849
LIABILITIES AND EQUITY:							
LIABILITIES:							
Debt on portfolio	527,900,000	460,900,000	360,900,000	297,500,000	230,500,000	171,373,000	126,573,000
Notes payable new SBIC loans	0	200,000,000	440,000,000	728,000,000	1,065,600,000	1,462,720,000	1,848,320,000
Total Liabilites	527,900,000	660,900,000	800,900,000	1,025,500,000	1,296,100,000	1,634,093,000	1,974,893,000
EQUITY:							
Preferred stock	200,000,000	200,000,000	200,000,000	200,000,000	200,000,000	200,000,000	200,000,000
Industry capital	20,000,000	22,600,000	25,600,000	29,080,000	33,136,000	37,883,200	42,630,400
Retained Earnings	0	7,338,337	11,999,356	14,735,379	15,295,484	12,537,482	12,292,472
Dividends	0	0	0	<736,023>	<736,023>	<736,023>	<736,023>
Total Equity	220,000,000	229,938,337	237,599,356	243,079,356	247,695,461	249,684,659	254,186,849
Total Liabilities and Equity	747,900,000	890,838,337	1,038,499,356	1,268,579,356	1,543,795,461	1,883,777,659	2,229,079,849
Debt/Capital Ratio	2.400	2.607	2.936	3.403	3.885	4.431	4.859

Year 7	Year 8	Year 9	Year 10	Year 11	Year 12	Year 13	Year 14	Year 15
48,827,374	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0
2,309,760,000	2,706,880,000	3,092,480,000	3,464,256,000	3,659,443,200	3,814,041,600	3,923,251,200	3,981,312,000	3,981,312,000
2,358,587,374	2,706,880,000	3,092,480,000	3,464,256,000	3,659,443,200	3,814,041,600	3,923,251,200	3,981,312,000	3,981,312,000
<182,220,800>	<208,358,400>	<229,888,000>	<245,888,000>	<255,252,460>	<261,181,440>	<264,314,880>	<265,420,800>	<265,420,800>
2,176,366,574	2,498,521,600	2,862,592,000	3,218,368,000	3,404,190,720	3,552,860,160	3,658,936,320	3,715,891,200	3,715,891,200
303,127,163	317,623,905	312,969,585	309,186,961	306,886,094	305,845,623	307,186,718	310,074,257	313,503,697
31,469,312	26,098,944	20,158,464	14,661,888	10,826,035	7,802,266	6,204,211	5,640,192	5,640,192
2,100,000	2,200,000	2,300,000	2,400,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
<1,260,000>	<1,480,000>	<1,710,000>	<1,950,000>	<550,000>	<550,000>	<550,000>	<550,000>	<550,000>
335,436,475	344,442,849	333,718,049	324,298,849	318,164,129	314,097,889	313,840,929	316,164,449	319,593,889
2,511,803,049	2,842,964,449	3,196,310,049	3,542,666,849	3,722,354,849	3,866,958,049	3,972,777,249	4,032,055,649	4,035,485,089
30,773,000	0	0	0	0	0	0	0	0
2,220,096,000	2,575,283,200	2,921,881,600	3,261,491,200	3,436,032,000	3,575,808,000	3,677,184,000	3,732,480,000	3,732,480,000
2,250,869,000	2,575,283,200	2,921,881,600	3,261,491,200	3,436,032,000	3,575,808,000	3,677,184,000	3,732,480,000	3,732,480,000
200,000,000	200,000,000	200,000,000	200,000,000	200,000,000	200,000,000	200,000,000	200,000,000	200,000,000
47,377,600	52,124,800	56,872,000	61,619,200	64,766,400	67,593,600	70,036,800	72,019,200	73,448,640
14,580,637	17,159,021	22,218,169	29,335,713	38,077,380	47,750,078	58,162,116	69,129,099	80,377,725
<1,024,188>	<1,602,573>	<4,661,721>	<9,779,264>	<16,520,931>	<24,193,629>	<32,605,667>	<41,572,650>	<50,821,276>
260,934,049	267,681,249	274,428,449	281,175,649	286,322,849	291,150,049	295,593,249	299,575,649	303,005,089
2,511,803,049	2,842,964,449	3,196,310,049	3,542,666,849	3,722,354,849	3,866,958,049	3,972,777,249	4,032,055,649	4,035,485,089
5.079	5.410	5.794	6.188	6.345	6.474	6.567	6.606	6.566

COSBI

RECOURSE - PREFERRED STOCK WITH DIVIDEND
$200,000,000 new loan base
increasing 20% first five years

INCOME STATEMENT	Initial	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
BANKING ACTIVITY:							
Interest income on old portfolio	0	75,761,000	66,701,000	54,803,000	43,726,000	31,146,000	20,223,000
Interest spread earned on new SBIC loans	0	1,000,000	3,200,000	5,840,000	8,968,000	12,641,600	16,555,200
Amortization of premium	0	<3,312,705>	<3,063,216>	<2,645,482>	<2,238,399>	<1,696,996>	<1,116,153>
Reinvestment income	0	1,491,548	3,299,626	5,523,335	8,639,942	12,220,488	16,681,608
Interest on debt for old portfolio	0	<44,398,000>	<38,960,000>	<31,211,000>	<25,257,000>	<19,744,000>	<13,936,000>
Losses on old portfolio, net of recoveries	0						
	0						
Provision for loan losses on new loans		<16,000,000>	<19,200,000>	<23,040,000>	<27,648,000>	<33,177,600>	<33,177,600>
Net Portfolio Income(Loss)	0	14,541,843	11,977,409	9,269,852	6,190,544	1,389,492	5,230,055
OPERATING ACTIVITY:							
License fees	0	100,000	100,000	100,000	100,000	100,000	100,000
MESBIC Reimbursement	0	500,000	525,000	551,250	578,813	607,753	607,753
Examination fees	0	1,900,000	2,000,000	2,100,000	2,200,000	2,300,000	2,400,000
Examination costs	0	<1,900,000>	<2,000,000>	<2,100,000>	<2,200,000>	<2,300,000>	<2,400,000>
Program Costs	0	<706,875>	<989,625>	<1,039,106>	<1,091,062>	<1,145,615>	<1,145,615>
Corporate Costs	0	<3,166,275>	<4,390,635>	<4,566,507>	<4,749,651>	<4,940,421>	<4,963,421>
Depreciation	0	<150,000>	<160,000>	<170,000>	<180,000>	<190,000>	<200,000>
Operating Costs	0	<3,423,150>	<4,915,260>	<5,124,363>	<5,341,900>	<5,568,283>	<5,601,283>
Net Income Before Taxes	0	11,118,693	7,062,149	4,145,489	848,643	<4,178,790>	<371,228>
Federal Income Taxes	0	3,780,356	2,401,131	1,409,466	288,539	<1,420,789>	<126,217>
Net Income	0	7,338,337	4,661,019	2,736,023	560,105	<2,758,002>	<245,010>

Year 7	Year 8	Year 9	Year 10	Year 11	Year 12	Year 13	Year 14	Year 15
13,493,000	1,747,000	0	0	0	0	0	0	0
20,342,080	23,976,896	27,485,824	30,916,864	33,487,616	35,059,200	36,264,960	37,048,320	37,324,800
<74,209>	<0>	0	0	0	0	0	0	0
17,314,929	18,187,630	19,057,434	18,778,175	18,551,218	18,413,286	18,350,737	18,431,203	18,604,455
<8,797,000>	<1,160,000>	0	0	0	0	0	0	0
<33,177,600>	<33,177,600>	<33,177,600>	<33,177,600>	<33,177,600>	<33,177,600>	<33,177,600>	<33,177,600>	<33,177,600>
9,101,200	9,573,925	13,365,658	16,517,439	18,861,234	20,294,886	21,438,097	22,301,923	22,751,655
100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000
607,753	607,753	607,753	607,753	607,753	607,753	607,753	607,753	607,753
2,500,000	2,600,000	2,700,000	2,800,000	2,900,000	3,000,000	3,100,000	3,200,000	3,300,000
<2,500,000>	<2,600,000>	<2,700,000>	<2,800,000>	<2,900,000>	<3,000,000>	<3,100,000>	<3,200,000>	<3,300,000>
<1,145,615>	<1,145,615>	<1,145,615>	<1,145,615>	<1,145,615>	<1,145,615>	<1,145,615>	<1,145,615>	<1,145,615>
<4,986,421>	<5,009,421>	<5,032,421>	<5,055,421>	<5,078,421>	<5,101,421>	<5,124,421>	<5,147,421>	<5,170,421>
<210,000>	<220,000>	<230,000>	<240,000>	<100,000>	<100,000>	<100,000>	<100,000>	<100,000>
<5,634,283>	<5,667,283>	<5,700,283>	<5,733,283>	<5,616,283>	<5,639,283>	<5,662,283>	<5,685,283>	<5,708,283>
3,466,917	3,906,643	7,665,376	10,784,156	13,244,951	14,655,603	15,775,815	16,616,640	17,043,373
1,178,752	1,328,259	2,606,228	3,666,613	4,503,283	4,982,905	5,363,777	5,649,658	5,794,747
2,288,165	2,578,384	5,059,148	7,117,543	8,741,668	9,672,698	10,412,038	10,966,983	11,248,626

COSBI

RECOURSE - PREFERRED STOCK WITH DIVIDEND
$200,000,000 new loan base
increasing 20% first five years

CASHFLOW	Initial	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Net income		7,338,337	4,661,019	2,736,023	560,105	<2,758,002>	<245,010>
Depreciation		150,000	160,000	170,000	180,000	190,000	200,000
Provision for new loan losses		16,000,000	19,200,000	23,040,000	27,648,000	33,177,600	33,177,600
Premium amortization old portfolio		3,312,705	3,063,216	2,645,482	2,238,399	1,696,996	1,116,153
Funds from operations		26,801,043	27,084,235	28,591,505	30,626,503	32,306,594	34,248,742
Issuance of preferred stock	200,000,000						
Issuance of debt for old portfolio	527,900,000						
Debt for new SBIC loans		200,000,000	240,000,000	288,000,000	345,600,000	414,720,000	414,720,000
Capital contribution	20,000,000	2,600,000	3,000,000	3,480,000	4,056,000	4,747,200	4,747,200
Recoveries of defaults,net		0	0	0	0	0	0
Principal receipts on old portfolio including default recoveries		73,173,580	113,605,580	91,941,580	106,773,580	119,421,580	46,959,000
Total Sources	747,900,000	302,574,623	383,689,815	412,013,085	487,056,083	571,195,374	500,674,942
Investment in old portfolio	721,540,860						
New SBIC loans		200,000,000	240,000,000	288,000,000	345,600,000	414,720,000	414,720,000
Purchase equipment	1,500,000		100,000	100,000	100,000	100,000	100,000
Principal payments on debt for old portfolio		67,000,000	100,000,000	63,400,000	67,000,000	59,127,000	44,800,000
Principal payments new debt		0	0	0	8,000,000	17,600,000	29,120,000
Dividends	0	0	0	736,023	0	0	0
Tax payments in excess of (less than) provision		5,440,000	6,528,000	7,833,600	6,680,320	5,296,384	1,379,584
Total Uses	723,040,860	272,440,000	346,628,000	360,069,623	427,380,320	496,843,384	490,119,584
Increase (decrease) in cash	24,859,140	30,134,623	37,061,815	51,943,462	59,675,763	74,351,990	10,555,358
Cash beginning	0	24,859,140	54,993,762	92,055,577	143,999,040	203,674,803	278,026,793
Cash ending	24,859,140	54,993,762	92,055,577	143,999,040	203,674,803	278,026,793	288,582,151

Year 7	Year 8	Year 9	Year 10	Year 11	Year 12	Year 13	Year 14	Year 15
2,288,165	2,578,384	5,059,148	7,117,543	8,741,668	9,672,698	10,412,038	10,966,983	11,248,626
210,000	220,000	230,000	240,000	100,000	100,000	100,000	100,000	100,000
33,177,600	33,177,600	33,177,600	33,177,600	33,177,600	33,177,600	33,177,600	33,177,600	33,177,600
74,209	0	0	0	0	0	0	0	0
35,749,975	35,975,985	38,466,748	40,535,143	42,019,268	42,950,298	43,689,638	44,244,583	44,526,226
414,720,000	414,720,000	414,720,000	414,720,000	414,720,000	414,720,000	414,720,000	414,720,000	414,720,000
4,747,200	4,747,200	4,747,200	4,747,200	3,147,200	2,827,200	2,443,200	1,982,400	1,429,440
4,800,000	10,560,000	17,472,000	25,766,400	35,719,680	40,872,960	45,066,240	48,107,520	49,766,400
106,691,426	48,827,374	0	0	0	0	0	0	0
566,708,601	514,830,559	475,405,948	485,768,743	495,606,148	501,370,458	505,919,078	509,054,503	510,442,066
414,720,000	414,720,000	414,720,000	414,720,000	414,720,000	414,720,000	414,720,000	414,720,000	414,720,000
100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000
95,800,000	30,773,000	0	0	0	0	0	0	0
42,944,000	59,532,800	68,121,600	75,110,400	80,179,200	82,944,000	82,944,000	82,944,000	82,944,000
288,165	578,384	3,059,148	5,117,543	6,741,668	7,672,698	8,412,038	8,966,983	9,248,626
<1,688,576>	<5,370,368>	<5,940,480>	<5,496,576>	<3,835,853>	<3,023,770>	<1,598,054>	<564,019>	0
552,163,589	500,333,816	480,060,268	489,551,367	497,905,015	502,412,928	504,577,983	506,166,963	507,012,626
14,545,011	14,496,742	<4,654,320>	<3,782,624>	<2,298,867>	<1,042,470>	1,341,094	2,887,539	3,429,440
288,582,151	303,127,163	317,623,905	312,969,585	309,186,961	306,888,094	305,845,623	307,186,718	310,074,257
303,127,163	317,623,905	312,969,585	309,186,961	306,888,094	305,845,623	307,186,718	310,074,257	313,503,697

TESTIMONY

BY

PATRICK OWEN BURNS

PRESIDENT

OF

R & D FUNDING CORPORATION

BEFORE THE

HOUSE SMALL BUSINESS COMMITTEE

SUBCOMMITTEE ON

SBA AND THE GENERAL ECONOMY

FEBRUARY 23, 1988

GOOD AFTERNOON CHAIRMAN LAFALCE AND MEMBERS OF THE SUBCOMMITTEE. I AM PATRICK OWEN BURNS, PRESIDENT OF R&D FUNDING CORPORATION IN NEW YORK, NEW YORK.

I APPEAR BEFORE THE SUBCOMMITTEE TODAY AS SOMEONE WHO HELPED TO PIONEER THE MESBIC INDUSTRY IN THE EARLY SEVENTIES, PARTICIPATED IN THE INDUSTRY'S LEADERSHIP FOR SEVERAL YEARS, INCLUDING TWO YEARS AS CHAIRMAN OF THE INDUSTRY'S TRADE ASSOCIATION, AND, IN 1985, LEFT THE INDUSTRY WITH VERY SERIOUS DOUBTS ABOUT THE INDUSTRY'S FUTURE.

THE ADMINISTRATION'S BUDGET PROPOSAL FOR THE MESBIC PROGRAM THIS YEAR SERVES TO CONFIRM MY DOUBTS. AS YOU ARE AWARE, THE ADMINISTRATION HAS PROPOSED ELIMINATING DIRECT FUNDING FOR MESBICS, AND TRANSFERING THE INDUSTRY TO THE SBIC FUNDING CORPORATION. THIS IS NOT AN ATTEMPT TO ACHIEVE BUDGET SAVINGS--THIS IS A BALD-FACED EFFORT TO KILL THE INDUSTRY AND THE DEVELOPMENT OF THE MINORITY SMALL BUSINESS COMMUNITY THEY SERVE. BY ELIMINATING THEIR DIRECT FUNDING, THE ADMINISTRATION WOULD ELIMINATE ALL INCENTIVES FOR NEW COMPANIES TO ENTER THE INDUSTRY. WHO IN HIS RIGHT MIND WOULD PAY THE SAME COST OF MONEY AS A REGULAR SBIC, BUT RESTRICT HIMSELF TO INVESTING IN ONLY A VERY SMALL PERCENTAGE OF ELIGIBLE SBIC INVESTMENTS THAT ARE OWNED BY MINORITIES? WHEN YOU ELIMINATE THE SPECIAL INCENTIVES MESBICS RECEIVE IN COMPENSATION FOR THEIR SPECIALIZED INVESTMENT POLICIES, YOU KILL THE INDUSTRY.

FOR 15 YEARS, I SERVED AS PRESIDENT OF MINORITY EQUITY CAPITAL COMPANY (MECCO) IN NEW YORK, NEW YORK. MECCO WAS ORGANIZED IN 1971 WITH INITIAL PRIVATE CAPITAL OF $1 MILLION PROVIDED BY FIVE INVESTORS: METROPOLITAN LIFE INSURANCE COMPANY, INTERRACIAL COUNCIL FOR BUSINESS OPPORTUNITY (ICBO), THE FORD FOUNDATION, THE DOMESTIC AND FOREIGN MISSIONARY SOCIETY OF THE EPISCOPAL CHURCH, AND AN INDIVIDUAL INVESTOR. FNCB CAPITAL CORPORATION (A SUBSIDIARY OF CITICORP) AND IBM LATER JOINED THE ORIGINAL INVESTORS, PROVIDING AN ADDITIONAL $1.6 MILLION.

WHEN I HELPED TO SET UP MECCO'S OPERATIONS BACK IN 1971, I REALIZED THAT THE NEW MESBIC INDUSTRY HAD SET FOR ITSELF IMPRESSIVE AND FAR-REACHING GOALS IN FACILITATING THE ECONOMIC EMPOWERMENT OF THE MINORITY BUSINESS COMMUNITY. I ALSO REALIZED THAT THE PUBLIC/PRIVATE SECTOR PARTNERSHIP NATURE OF THE INDUSTRY WAS WHAT COULD MAKE THE DIFFERENCE IN TERMS OF THE INDUSTRY'S ACHIEVING ITS GOALS.

DURING MY FIFTEEN YEARS IN THE MESBIC INDUSTRY,I SAW THE PROGRAM GROW FROM A SMALL GROUP OF COMPANIES INVESTING AN AVERAGE OF LESS THAN $13,000 IN MOM-AND-POP TYPE ESTABLISHMENTS TO AN INDUSTRY OF ALMOST 150 COMPANIES, INVESTING AN AVERAGE OF $100,000 AND, VERY OFTEN, SYNDICATING MULTI-MILLION DOLLAR DEALS, ATTRACTING HUNDREDS OF MILLIONS OF DOLLARS TO MINORITY BUSINESSES FROM OTHER PRIVATE SECTOR INVESTORS.

THESE FIGURES INDICATE NOT ONLY THE DEVELOPMENT OF THE MESBIC INDUSTRY, BUT THE INCREASING SOPHISTICATION OF THE MINORITY SMALL BUSINESS COMMUNITY IN WHICH MESBICS INVEST.

THE SUCCESS OF THE MESBIC INDUSTRY IS NOT BASED SOLELY ON THE RETURN ON INVESTMENT THEY OFFER TO THEIR INVESTORS. THE LARGER PART OF THEIR SUCCESS IS MEASURED IN THEIR EFFECT ON THE MINORITY BUSINESS COMMUNITY, WHICH HAS MADE REMARKABLE STRIDES THROUGH THE INDUSTRY'S EFFORTS. IF YOU WERE TO REVIEW A LIST OF THE MOST SUCCESSFUL MINORITY ENTERPRENEURS DURING THE PAST TWO DECADES, YOU WOULD HAVE SOME DIFFICULTY IN IDENTIFYING MORE THAN A HANDFUL WHO AT SOME TIME HAD NOT BEEN CONNECTED WITH THE MESBIC INDUSTRY. A WHOLE GENERATION OF SOPHISTICATED MINORITY ENTREPRENEURS AND MANAGERS HAVE BEEN GIVEN THE OPPORTUNITY TO CUT THEIR EYE TEETH THROUGH THE MESBIC COMMUNITY. THE MESBIC PROGRAM HAS DEVELOPED SKILLS OF GREAT SOCIAL AND ECONOMIC UTILITY, BUT THEIR TASK HAS ONLY PARTIALLY BEGUN.

UNFORTUNATELY, SEVERAL NEGATIVE TRENDS HAVE DEVELOPED WITHIN THE LAST FEW YEARS THAT THREATEN THEIR CONTINUED PROGRESS. GOVERNMENT LEVERAGE OF MESBICS HAS GONE FROM ITS PEAK OF $45 MILLION TO ITS CURRENT LEVEL OF $36 MILLION--AN AMOUNT THAT IS GROSSLY INSUFFICIENT IN MEETING THEIR LEVERAGE NEEDS. MESBICS ARE UNABLE TO OBTAIN LEVERAGE ON A TIMELY BASIS, JEOPARDIZING NOT ONLY THE MESBICS' OPERATIONS, BUT THOSE OF THE SMALL BUSINESSES IN WHICH THEY HAVE INVESTED. UNCERTAINTY REGARDING THE FUTURE AVAILABILITY OF MATCHING FUNDS HAS KEPT

THE PRIVATE SECTOR FROM INVESTING IN THE INDUSTRY. THUS, MESBICs AND THE MINORITY SMALL BUSINESSES IN WHICH THEY INVEST ARE BEING CUT OFF FROM BOTH THEIR PUBLIC AND PRIVATE SECTOR SOURCES OF CAPITAL. THE NUMBER OF MESBIC LICENSEES SHRUNK FROM ITS 1985 HIGH OF 146 TO 128 BY THE END OF 1987. THE AMOUNT MESBICs INVESTED LAST YEAR WAS SLIGHTLY LOWER THAN IN 1986, AND THIS IS A TREND THEY EXPECT TO SEE CONTINUE UNLESS THEY OBTAIN FUNDING STABILITY.

I WANT TO STRESS HERE THE IMPORTANCE NOT ONLY OF THE LEVEL OF FUNDING MESBICs RECEIVE, BUT OF THE STABILITY OF THAT FUNDING. VENTURE CAPITALISTS HAVE A SAYING, "I DON'T CARE WHAT THE NEWS IS, I JUST DON'T WANT ANY SURPRISES." WE ENCOURAGE OUR PORTFOLIO ENTREPRENEURS TO SHARE ALL INFORMATION WITH US, GOOD OR BAD, SO THAT WE CAN WORK WITH THEM TO OVERCOME PROBLEMS, AND TO HELP THEM PLAN FOR THE FUTURE. THE SITUATION IN WHICH MESBICs HAVE BEEN PLACED RUNS CONTRARY TO ALL THE ADVICE THEY GIVE THEIR PORTFOLIO COMPANIES. THEY CAN'T WORK WITH THEIR PRIVATE INVESTORS TO PLAN FOR THE FUTURE, BECAUSE THEY HAVE ABSOLUTELY NO IDEA WHAT THE FUTURE HOLDS.

THIS INSTABILITY LEADS TO UNCERTAINTY ON THREE DIFFERENT LEVELS. FIRST, IT INHIBITS A MESBIC'S ABILITY TO PLAN RATIONALLY ITS FUTURE ACTIVITIES. SECOND, MESBIC PORTFOLIO COMPANIES ARE UNABLE TO PLAN ON A CONTINUUM OF SUPPORT FROM THEIR MESBIC INVESTORS. AND THIRD, IT LEADS TO AN UNCERTAIN FUTURE FOR MESBIC EXECUTIVES. BEING A MESBIC INVESTMENT EXECUTIVE IS VERY DIFFERENT FROM BEING ANY OTHER TYPE OF

VENTURE CAPITALIST. WE DEAL WITH A VERY SPECIALIZED SLICE OF ECONOMIC ACTIVITY. MESBICS ADDRESS THE NEEDS OF COMPANIES IN AN ECONOMIC AREA NOT ADDRESSED BY OTHER FINANCING SOURCES. THERE IS A NEED IN THE MESBIC INDUSTRY TO DEVELOP A CORPS OF INCREASINGLY EXPERIENCED MINORITY BUSINESS INVESTORS. BUT IT CAN BECOME HARD TO MAINTAIN THAT CORPS WHEN THEIR FUTURE IS SO UNCERTAIN. I LEFT THE MESBIC INDUSTRY FOR SEVERAL REASONS, NOT THE LEAST OF WHICH WAS THE UNCERTAINTY. I OFTEN TELL FRIENDS WHO ASK ABOUT THE REASON FOR MY DEPARTURE THAT I LEFT BECAUSE MY TWO CHILDREN STARTED TO ENJOY EATING.

I'M NOT TRYING TO BE FLIPPANT, BUT THE RECENT DOWNHILL TRENDS IN THE MESBIC INDUSTRY BECOME PARTICULARLY DISTURBING WHEN YOU EXAMINE THE PROMISE THE INDUSTRY SHOWED JUST A FEW SHORT YEARS AGO, WHEN NEW LICENSEES AND PRIVATE CAPITAL WERE STREAMING INTO THE INDUSTRY. ONE IS FORCED TO QUESTION WHAT COULD CAUSE SUCH A DRASTIC CHANGE. WHY HAS THE ADMINISTRATION CONTINUED TO TRY TO CUT BACK, AND IN SOME CASES, ELIMINATE ITS SHARE IN A PARTNERSHIP THAT HAS DEMONSTRATED SUCH AN IMPRESSIVE RECORD IN MINORITY BUSINESS DEVELOPMENT, JOB CREATION, AND TAX REVENUE GENERATION? IT JUST DOESN'T MAKE SENSE. GIVEN THE TIMING OF THESE ATTEMPTS, AT THE PEAK OF THE MESBIC INDUSTRY'S PERFORMANCE, IT BECOMES EVEN MORE PUZZLING.

AS SOMEONE WHO DEALT WITH THE FUNDING AND REGULATORY INSTABILITY AT THE SBA FOR A NUMBER OF YEARS, I COULD NOT HELP BUT TO SENSE A BASIC NEGATIVE VIEW IN THE SBA TOWARD THE PROCESS OF CAPITAL FORMA-

TION. I BELIEVE A LOT OF PEOPLE AT THE SBA VIEW THE MESBIC INDUSTRY AS A POVERTY PROGRAM, AND ARE UNCOMFORTABLE WITH THE FACT THAT IT HAS BECOME PROFITABLE, AS WAS ORIGINALLY INTENDED. THIS DISCOMFORT WITH PROFITABILITY HAS NURTURED A CERTAIN LEVEL OF HOSTILITY, RATHER THAN A CONTINUATION OF THE PARTNERSHIP RELATIONSHIP WITH BOTH PARTNERS WORKING TOWARD A MUTUAL GOAL. I CAN THINK OF NOTHING BETTER TO ILLUSTRATE THIS POINT THAN THIS YEAR'S ADMINISTRATION BUDGET PROPOSAL, WHICH COMPLETELY ELIMINATES THE SPECIAL INCENTIVES TO MESBICS TO INVEST IN MINORITY OWNED SMALL BUSINESSES. MESBICS ARE EXPECTED TO PAY THE SAME COST OF MONEY AS REGULAR SBICS, BUT TO CONTINUE TO KEEP THEIR INVESTMENTS IN A VERY NARROW SEGMENT. THIS PROPOSAL DEMONSTRATES A COMPLETE LACK OF COMMITMENT TO THE MINORITY BUSINESS COMMUNITY. YET WE KNOW THAT SOME OF THE PEOPLE WHO HELPED TO PUT THIS PROPOSAL TOGETHER ARE THE VERY SAME PERSONS WHO ARE SUPPOSED TO BE OUR PARTNERS IN DEVELOPING THAT COMMUNITY--THE SBA.

I'M NOT SAYING THAT THE PRIVATE SECTOR PARTNERS IN THE MESBIC PROGRAM CAN DO IT ON THEIR OWN--THEY CAN'T. ON THE OTHER HAND, THEIR CURRENT PARTNERS AT THE SBA SEEM TO BE MORE OF A HINDRANCE THAN A HELP TO THEIR PROGRESS. THAT IS WHY THE MESBIC INDUSTRY SO DESPERATELY NEEDS COSBI.

COSBI IS A CREATIVE AND TIMELY RESOLUTION TO THE NEGATIVE TRENDS THAT HAVE BEEN DEVELOPING IN THE INDUSTRY. H.R. 3392 ADDRESSES THE NEEDS FOR APPROPRIATE REGULATION OF THE INDUSTRY GIVEN THE GOVERNMENT

INVESTMENT IN THE PROGRAM AT THE SAME TIME IT PROVIDES AN OPPORTUNITY FOR GROWTH. THROUGH THE PASSAGE OF H.R. 3392, MESBICS, AND THE MINORITY SMALL BUSINESSES IN WHICH THEY INVEST, WILL FINALLY ACHIEVE THEIR LONG-SOUGHT STABILITY.

I WOULD LIKE TO TAKE THIS OPPORTUNITY TO THANK YOU FOR ALLOWING ME TO APPEAR BEFORE THIS SUBCOMMITTEE TODAY, AND WOULD BE HAPPY TO ANSWER ANY OF YOUR QUESTIONS.

STATEMENT OF

GARY W. KALBACH

GENERAL PARTNER, EL DORADO VENTURES

CUPERTINO, CALIFORNIA

before the

SUBCOMMITTEE ON SBA AND THE GENERAL ECONOMY

of the

COMMITTEE ON SMALL BUSINESS

U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 23, 1988

$2,600,000 of paid-in capital. Over half of this was capital recontributed from a successful investment made in 1979.

From 1980 to 1982, West Coast Venture Capital borrowed $4,400,000 from the Small Business Administration on five to seven year notes. With paid-in capital of $2,600,000, this represented leverage of 1.7 times our equity base and left us with a theoretical borrowing capacity of an additional $6 million.

From 1979 through 1982, West Coast Venture Capital invested $6,700,000 in 13 small business companies. Seven of these companies were seed financings of start-up companies and six were early-stage investments in small business concerns with less than twenty-five employees and virtually no sales.

I would like to share with you the results of these investments. Of the thirteen companies, four failed over time. Six of these companies grew in sales to a combined level of $55 million and our positions in those firms were sold successfully. Three of these companies grew significantly and were taken to the public market in very successful initial public offerings.

Of these three public companies, I will tell you about two of them --- Integrated Device Technology and Sun Microsystems.

Integrated Device Technology was started in the conference room of West Coast Venture Capital by the founding team of engineers with assistance from two of the limited partners of West Coast Venture Capital. Our initial investment was $200,000. The other initial investors in the company were two other SBIC's --- Union Venture Corporation and First Interstate Capital Corporation. It is fair to say that Integrated Device Technology would never have been started without the SBIC program. The founders had been to a number of venture groups and were turned down because their business plan was incomplete. Integrated Device Technology manufacturers advanced semiconductor devices. Its primary market is the United States military.

Today, Integrated Device Technology has 1,142 employees; it has sales in excess of $100 million a year; and in 1987, it paid federal income taxes in excess of $4 million. The company continues to supply the United States military with critical components for various weapons and missiles.

The second investment I would like to tell you about was in Sun Microsystems. In 1982, West Coast Venture Capital was the initial investor in Sun Microsystems with a $125,000 commitment to the three founders in order to start the company. Today, the company employs 5,465 people; its 1988 sales will exceed $1 billion; and it will pay federal income taxes of $32 million in its current fiscal year ending in June.

As the General Partner of West Coast Venture Capital, I started with $1 million from my investors and returned over $75 million to them after repaying the SBA $4,400,000 plus interest. This remains one of the most successful investment records in the history of venture capital investing.

Early in 1982, as we were investing in Sun Microsystems, the SBA announced to us that they had changed their mind relative to the investment objectives under which we were licensed. They said they did not believe that it was appropriate for us to invest in small business companies on a venture basis. They felt that equity investing in technology-based companies was not commensurate with the goals of the SBIC program. We had never been in violation of the spirit or the letter of the SBA regulations. We invested only in accordance with the investment objectives stated in our approved license application to the SBA. They simply had a policy change! They granted us our final loan in 1982 and told us there would be no more leverage. They strongly suggested that we change our investment policy to non-venture investments in lower-technology companies. Through a number of discussions with the SBA, we made it clear that we were not willing to alter what we felt was the proper investment policy for our group. Our attorneys advised that we should bring suit against the SBA on the basis that they reneged on the license they granted to us in 1979. We decided against a lawsuit in favor of closing West Coast Venture Capital investment operations and liquidating the partnership. No doubt, this has been detrimental to many potential business concerns which have not been funded. It was the intent of the partners of West Coast Venture Capital to invest, substantially, all of the profits back into the fund, as they had earlier, for investment into small businesses.

Of the $75 million in securities that were distributed to the limited partners, most have been sold, and, I would estimate, $20 million in federal income taxes paid. The $50 million of net profits to these investors have been reinvested primarily in real estate, not in small business --- simply because the SBA arbitrarily decided that we should not be investing as venture capital investors through the SBIC program. If West Coast was a continuing licensee of the SBIC program, it's fair to say that a significant portion of the $50 million net profit would have been re-contributed to the partnership and reinvested in new, small business concerns.

I firmly believe that through its arbitrary policy changes and lack of understanding of investing in small business companies, the Small Business Administration forced the closure of West Coast Venture Capital.

As a nation today, we are struggling to create jobs, to generate federal tax dollars, and to balance our trade deficit. Through its investment of $6,700,000, my venture partnership helped create over 6,500 jobs; generate $100 million in federal tax revenue; and create state-of-the-art technology for the United States military and for export to foreign countries. We could have done more, but the SBA decided that this type of investing was not appropriate. They had little understanding of what we were doing.

I would strongly encourage you to adopt H.R. 3392, the COSBI legislation. This will take away the bureaucratic and arbitrary administration of a program that was created to stimulate small business growth.

STATEMENT OF

FREDERICK J. BESTE III

PRESIDENT, NEPA MANAGEMENT CORPORATION
BETHLEHEM, PENNSYLVANIA

before the

SUBCOMMITTEE ON SBA AND THE GENERAL ECONOMY
of the
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 23, 1988

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

Good afternoon. I am Fred Beste, President and Chief Executive Officer of NEPA (Northeastern Pennsylvania) Management Corp., which is the general partner of NEPA Venture Fund, L.P. (NVF), an $11 million non-SBIC venture capital partnership located in Bethlehem, Pennsylvania. Prior to forming NVF, I was, for 14 years, associated with two SBIC's, Greater Washington Investors, Inc. (Bethesda, MD) and Mountain Ventures, Inc. (London, KY). Greater Washington is a 28-year old SBIC which invests nationally, primarily in young technology-based businesses. Mountain Ventures is a nine-year old, wholly-owned subsidiary of Kentucky Highlands Investment Corp., an economic development firm located in London, Kentucky, in the Appalachian portion of the state. My first employment by an SBIC dates back to 1966.

I would like to briefly share with you some of my experiences as an SBIC manager; the reasons why those of us who founded NVF elected not to set up as an SBIC; and what impact that is having on the Northeastern quadrant of Pennsylvania.

As I am certain you have heard from others, risk capital investing is an exciting business in any form. Over the years, however, the Small Business Administration (SBA) has unfortunately made such investing in SBIC form clearly the most exciting in the land.

The SBA/SBIC "compact" could hardly be simpler. If one agrees to invest only in American small business according to certain rules, one can borrow through the SBA up to four times the private capital of the SBIC. Clearly, but for the ability to make such borrowings, there is no incentive whatsoever to invest in SBIC form.*

Over the years in which I was associated with SBIC's, there were only two problems with the compact. The "certain rules" kept changing and the ability to borrow ranged from assured to uncertain to impossible.

Much has been written about the unfortunate, short-term, quarter-to-quarter mentality of much of corporate America. By and large, SBIC managers must think longer term. They raise their private capital out of their own pockets and/or from investors who are attracted to their particular investment strategy. They place their capital into the securities of non-controlled private companies with the expectation of being at risk in those companies for a period of four to seven years or more.

Unfortunately, during the years in which I was involved in the program, fundamental and arbitrary changes in the program were frequently made by the SBA. A few examples should suffice:

* Except for banks, which otherwise face Glass-Steagall Act restrictions on such investment activities.

- SBA has forced certain SBIC's to invest a fixed proportion of their funds in straight equity securities, a requirement unmentioned in either the enabling legislation or regulations

- In a continuing contravention of free market forces, SBA has changed, tuned, tweaked and otherwise complicated the formula for determining "cost of money" limitations to the point where I wonder if anyone truly currently understands them

- Long-successful SBIC's which prospered in large part by concentrating their activities in an industry in which they had exceptional knowledge and contacts, have been arbitrarily ordered to "diversify" by the SBA

I would underscore the fact that these changes were not addressing poor regulatory draftsmanship, loopholes or abuses. They represented basic, mid-stream changes made by the licensing agency.

With respect to leverage, the very heart of the SBIC program, I have seen SBA-direct lending punctuated by a two-year drought, publicly auctioned financings punctuated by completely unpredictable timing and Federal Financing Bank lending punctuated by lending ceilings.

When those of us who founded NVF drafted the offering memorandum we used to attract capital, it included the following language:

> Possible Formation of a Small Business Investment Company
>
> To provide more leverage to the Fund to make advantageous investments and to increase the likelihood that capital will be available for follow-on investments in Portfolio Companies in the later years of the life of the Fund, the General Partner will be authorized by the Partnership Agreement to create a Small Business Investment Company ("SBIC") to be wholly-owned by the Fund. Before the SBIC could begin operations, a license would be required to be obtained from the U.S. Small Business Administration ("SBA"). No assurance can be given that the required license would be granted.
>
> The Fund cannot currently determine whether the SBIC affiliate, when and if formed, would be able to obtain.....borrowings. Further, no assurance can be given that, at the time the SBIC determines to make any such borrowings, SBA guarantees will be available or that the law then prevailing will permit SBA-guaranteed borrowings on the same favorable terms as are permitted under current law.

Our optimum capitalization objective was $20 million, a lofty one inasmuch as we were the first venture capital partnership to ever attempt formation in the Eastern half of Pennsylvania other than in the immediate vicinity of Philadelphia. Northeastern Pennsylvania, our target investment area, has a proud industrial tradition but its five centers of commerce (Scranton, Wilkes-Barre, Allentown, Bethlehem and Easton) are not known as hotbeds of entrepreneurship. I and my five local co-founders felt, however, that there was to be renewed vigor after anthracite coal and steel, and that it would likely lie in the small business sector.

We could have set up as an SBIC. Indeed, only $4 million of capital could have led, with full leverage, to our $20 million investment objective. However, the unstable condition of the program, particularly as related to the long-term assurance of leverage, was a strong dissuader. We therefore elected to set up as a limited partnership with the aforenoted option to use part of our funds to subsequently set up an SBIC subsidiary. We were able to raise $11 million.

We are almost three years into the life of our 10-year partnership now, and obviously have not set up an SBIC subsidiary given the current status of the program. The implications for our region? They are primarily two-fold. We will make about 18 fewer investments (at our preferred average investment level of $500,000) than we would have. And, since we ourselves are capitalized entirely with equity, we are largely ignoring area companies with SBIC-type needs, i.e., those that lie between straight equity and commercially financeable needs. This is particularly unfortunate since the venture capital industry tends to invest locally (or in conjunction with local partners), and there is only one very small SBIC in Northeastern Pennsylvania, which is restricted from making investments larger than $125,000. If the SBIC program had been predictably stable at the time of our launch, I am confident that we would have leveraged our capital base with an SBIC subsidiary. We had postured ourselves to do so. We would seriously consider the establishment of an SBIC if, in the future, the industry achieved that stable predictability.

I would be remiss if I neglected to comment on one other likely benefit of the establishment of COSBI, specifically the elimination of the frequent contentiousness of this public-private partnership, incredibly ironic given the SBIC program's marvelous success over almost three decades. While there have been many fine, cooperative moments in the history of the program, all too often those of us in the industry have felt a "we/they", "guilty until proven innocent" attitude from the agency. I can't help but recall my efforts to secure a license for Mountain Ventures, Inc. which was to be launched by its parent (my employer) to invest in companies located in the Appalachian third of Kentucky. Our region chief at the time unilaterally questioned the wisdom of this admittedly challenging strategy, and obfuscated, stonewalled and otherwise attempted to block and discourage our being licensed, notwithstanding my then nine years of venture capital experience, and the seven years of such experience by the proposed parent corporation. This nonetheless ultimately successful 19-month licensing ordeal had some truly laughable (only in retrospect) moments. For instance, we were told that a customary management interview could not be scheduled for the indefinite future because "our offices are being redecorated". Even after we finally prevailed and the license was reluctantly approved internally, written approval was denied us for a week because "our secretary is sick".

By the way, Mountain Ventures has operated profitably every year, and has invested over $1-1/2 million in seven companies in Appalachia which together employ 700 employees, more than half of which were created after its investment. Its "superstar" to date is Mt. Vernon Plastics Corp. Backed as a rank start-up, it now employs 250, and in fiscal year 1987 was solidly profitable on revenues of $15 million. While this will not make anyone forget about Apple Computer, 250 jobs make an unbelievable difference in a poor little town like Mt. Vernon, Kentucky.

Admittedly, Mountain Ventures is not a typical SBIC, although there are many other areas in the country where SBIC's represent the only local venture capital. And it is an excellent example of the diversity of the program, and of its uniqueness compared to the venture capital partnership side of the industry, which to date has shown no interest in the Mt. Vernons of this land. And I would submit that this is a fundamentally important characteristic of the SBIC program, as there are a whole lot more Mt. Vernons in this country than there are Palo Altos and Bostons.

The Combined Fund Inc.

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Chief Investment Officer
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TESTIMONY

BY

E. PATRIC JONES

PRESIDENT

OF

THE COMBINED FUND, INC.

BEFORE THE

HOUSE SMALL BUSINESS COMMITTEE

SUBCOMMITTEE ON

SBA AND THE GENERAL ECONOMY

FEBRUARY 23, 1988

1525 East 53rd Street • Suite 908 • Chicago, Illinois 60615 • 312-363-0300
A Federal licensee under the Small Business Investment Act of 1958.

GOOD MORNING MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE. I AM E. PATRIC JONES, PRESIDENT OF THE COMBINED FUND, INC. OF CHICAGO, ILLINOIS. I HAVE BEEN A PAST DIRECTOR, CHAIRMAN, VICE CHAIRMAN AND LEGISLATIVE CHAIRMAN OF THE NATIONAL ASSOCIATION OF INVESTMENT COMPANIES.

IN NO UNCERTAIN TERMS, OUR INDUSTRY'S CONTINUED EXISTENCE DEPENDS ON COSBI.

CURRENTLY, THERE ARE 128 LICENSED ACTIVE COMPANIES IN OUR INDUSTRY. IN DECEMBER 1986, THAT NUMBER WAS 145. IN 1985, 146, AND 1984, 144. IN 1983, SBA LICENSED 21 NEW MESBICS. THAT NUMBER WAS 9 IN 1984, 13 IN 1985, 8 IN 1986, AND 6 IN 1987. SINCE 1985, OUR INDUSTRY HAS SEEN A NET LOSS OF 18 COMPANIES, OR 14% OF OUR CURRENT INDUSTRY.

THE ESSENCE OF THE MESBIC PROGRAM HAS ALWAYS BEEN ITS INHERENT ABILITY TO ATTRACT PRIVATE CAPITAL TO THE INDUSTRY. IN 1980, OUR INDUSTRY'S PRIVATE CAPITAL GROWTH RATE WAS 27.4%. IN 1981, THAT GROWTH RATE FELL TO 11.6%; TO 9.2% IN 1982, 13% IN 1983, 8.3% IN 1984, 4.7% IN 1985 AND 1986, AND LESS THAN 1% IN 1987. SINCE 1980, THE PRIVATE CAPITAL GROWTH RATE OF OUR INDUSTRY HAS FALLEN ALMOST 27%. THAT'S A SIGNIFICANT OPPORTUNITY LOSS FOR MINORITY BUSINESS.

WHY?

WHY IS OUR INDUSTRY SHRINKING AT A TIME WHEN OUR TRACK RECORD IS GETTING BETTER AND BETTER? OUR PROFIT PERFORMANCE INCREASES EACH YEAR. OUR BALANCE SHEETS ARE STRONGER.

THE ANSWERS ARE SEVERAL:

1. UNCERTAINTY ABOUT THE FUTURE. INVESTORS RIGHTLY ASK WILL THERE BE A MESBIC PROGRAM NEXT YEAR? WILL THE PROGRAM BE ADMINISTERED BY THE SBA? WILL THERE BE AN SBA?

2. AVAILABILITY OF LEVERAGE DOLLARS. THE ESSENCE OF OUR PROGRAM IS THE ABILITY TO LEVERAGE PRIVATE DOLLARS. WITHOUT THAT INCENTIVE, MINORITY BUSINESS DOES NOT HAVE A PARTICULARLY HIGH PRIORITY WITH POTENTIAL CAPITAL SOURCES. LEVERAGE IS CRITICAL TO OUR INDUSTRY AND TO MINORITY BUSINESS.

ANNUALLY, WE SUFFER THE TRAUMA OF THE APPROPRIATIONS PROCESS. FURTHER, WE NEVER KNOW HOW MUCH OF THE CONGRESSIONALLY APPROPRIATED AMOUNT SBA WILL ACTUALLY DISBURSE; OR WHAT NEW RULES THEY WILL ARBITRARILY ISSUE FOR LEVERAGE QUALIFICATION; OR WHICH MESBICS WILL BE OUT OF FAVOUR AND THUS INELIGIBLE FOR LEVERAGE.

RIGHT NOW, BLOOD FLOWS FROM THE PROVERBIAL TURNIP MORE EASILY THAN LEVERAGE (PARTICULARLY PREFERRED STOCK) FLOWS FROM SBA. IT HAS GOTTEN TO THE POINT THAT SOME IN OUR INDUSTRY DON'T EVEN APPLY FOR LEVERAGE ANYMORE. ULTIMATELY, THE COST IN FRUSTRATION, WASTED TIME AND SECOND-GUESSING IS SIMPLY TOO HIGH!

3. REGULATORY-OVERSIGHT. CAPRICIOUS, ARBITRARY, INCONSISTENT AND IRRATIONAL INTERPRETATION OF REGULATIONS CAN BE CERTAIN DEATH TO AN INDUSTRY WHERE HUNDREDS OF MILLIONS OF DOLLARS ARE AT STAKE. WE ACCEPT THE NEED FOR GOVERNMENT OVERSIGHT

WHERE PUBLIC RESOURCES ARE INVOLVED. WE WELCOME IT. BUT WE ARE TRYING TO RUN BUSINESSES, HERE, NOT WELFARE PROGRAMS.

IN EVERY ONE OF OUR COMPANIES, IT IS THE PRIVATE CAPITAL THAT IS FIRST AT RISK. THE LEVERAGE DOLLARS WHICH WE RECEIVE FROM THE SBA ARE OBLIGATIONS, NOT GRANTS.

REGULATIONS SHOULD BE FAIR AND CONSISTENT WITH WHAT CONGRESS WRITES. OPERATING PARAMETERS SHOULD BE CLEAR AND OBJECTIVE; NOT SUBJECT TO ARBITRARY RE-INTERPRETATION.

AUDITORS SHOULD BE INTELLIGENT AND PROFESSIONAL, LIMITING THEIR SCOPE OF INQUIRY TO THAT PRESCRIBED BY LAW. ON AT LEAST TWO OCCASIONS, AN AUDITOR HAS DISCUSSED WITH ANOTHER INVESTMENT COMPANY SOME OF MY COMPANY'S MOST PRIVATE INFORMATION. CONFIDENTIALITY SHOULD BE PARAMOUNT.

IN 1985, AFTER SEVEN YEARS AS AN EMPLOYEE PRESIDENT OF MY COMPANY, I NEGOTIATED A DEAL TO ACQUIRE THE COMPANY FROM ITS OWNERS, THREE BANKS. HAVING ALWAYS FELT ENTREPRENEURIAL AND AFTER SERIOUSLY CONSIDERING BUYING A WIDGET COMPANY, I REASONED: WHAT COULD BE MORE ENTREPRENEURIALLY AMERICAN THAN TO TAKE A SOCIALLY MOTIVATED VEHICLE (THE MESBIC, CREATED TO DEVELOP MINORITY ENTREPRENEURS) AND TO MAKE THE VEHICLE ITSELF ENTREPRENEURIAL. IN OTHER WORDS: MINORITY ENTREPRENEURS, IF GIVEN THE CHANCE, CAN BE SO SUCCESSFUL THAT ANOTHER MINORITY COULD MAKE MONEY BY FINANCING THEM.

AS AN INDIVIDUAL VENTURE CAPITALIST, I CAN BE INNOVATIVE AND CAN TAKE SOME RISKS THAT THE FORMER OWNER BANKS COULD NOT. TWO EXAMPLES:

1. A YOUNG BLACK WOMAN IN CHICAGO HAS DEVELOPED A CABLE HOME SHOPPING SERVICE WHICH WENT ON THE AIR APRIL 1, 1987. STARTED FROM AN IDEA, THE COMPANY NOW REACHES ALMOST 400,000 SUBSCRIBERS. MY COMPANY INVESTED $30,000 AS ESSENTIALLY "SEED" MONEY. RECOGNIZING THAT THIS YOUNG WOMAN HAD WORKED HARD AND HAD ACCOMPLISHED MUCH AGAINST SIGNIFICANT ODDS, I DECIDED TO GIVE HER SOME SUPPORT. AS MY CO-INVESTOR SAID "LET'S PUT THE MONEY OUT THERE AND SEE WHAT HAPPENS". WE STILL HAVE OUR FINGERS CROSSED.

2. I PROVIDED $200,000 IN EQUITY FINANCING FOR A YOUNG REAL ESTATE DEVELOPMENT COMPANY. THEIR OBJECTIVE IS TO DO SIGNIFICANT DEVELOPMENT IN A CHICAGO AREA CALLED THE "GAP". BECAUSE OF MY EQUITY INFUSION, THE COMPANY WAS ABLE TO GET AN $800,000 BANK LOAN TO COMPLETE A FIRST PROJECT. NINE TOWN HOMES ARE UNDER CONSTRUCTION, SEVEN OF THEM HAVE BEEN SOLD AND IF CHICAGO'S WEATHER IS KIND, WE WILL TURN THEM OVER AROUND MAY 1. THIS AREA IS LOCATED ON CHICAGO'S SOUTHSIDE WHERE INSTITUTIONAL LENDERS HAVE NOT BEEN NOTED FOR THEIR EAGERNESS TO LEND. NOT ONLY ARE WE DEVELOPING SOME ENTREPRENEURS, WE ARE ALSO HELPING REVITALIZE AN ECONOMICALLY DEPRESSED AREA.

THESE ARE INNOVATIVE INVESTMENTS WHICH I AS AN INDIVIDUAL CAN MAKE. SOME INSTITUTIONAL STOCKHOLDERS DON'T HAVE THAT FLEXIBILITY.

SINCE MY ACQUISITION OF MY MESBIC, TWO OTHER SIMILAR ACQUISITIONS HAVE OCCURRED AND SEVERAL OTHERS ARE BEING NEGOTIATED. THAT IS HEALTHY FOR OUR INDUSTRY AND VERY GOOD FOR MINORITY BUSINESS. WITHOUT COSBI, HOWEVER, THE TREND IS UNLIKELY TO CONTINUE. HOW CAN AN ENTREPRENEUR SENSIBLY MAKE A LONG-TERM COMMITMENT TO AN INDUSTRY THAT DOESN'T HAVE A LONG-TERM?

FOR TWO YEARS, I HAVE BEEN TRYING TO RAISE ADDITIONAL CAPITAL. MY SUCCESS HAS BEEN MINIMAL. POTENTIAL CAPITAL SOURCES HAVE SERIOUS RESERVATIONS ABOUT WHERE SBA IS TAKING THE INDUSTRY AND ABOUT THE AVAILABILITY OF LEVERAGE FUNDS.

I SUBMITTED MY APPLICATION TO PURCHASE MY MESBIC ON AUGUST 5, 1985. I RECEIVED THE NECESSARY "TENTATIVE LETTER OF APPROVAL" FOUR MONTHS LATER. HOW LONG WOULD IT HAVE TAKEN HAD I NOT BEEN THE MANAGER OF THE COMPANY I WAS BUYING FOR SEVEN YEARS, AND HAD I NOT HAD FIVE YEARS OF LEADERSHIP EXPERIENCE IN OUR TRADE ASSOCIATION AND HAD I NOT KNOWN THE SENIOR PEOPLE AT SBA ON A FIRST NAME BASIS, AND HAD I NOT FLOWN TO WASHINGTON TWICE TO REVIEW EVERY DETAIL OF THE ACQUISITION PRIOR TO SUBMITTING THE APPLICATION?

I RECEIVED MY FINAL LETTER OF APPROVAL ELEVEN MONTHS LATER ON OCTOBER 27, 1986. HAVING REQUESTED NO LEVERAGE SINCE 1979, WE SUBMITTED AN APPLICATION IN OCTOBER LAST YEAR. THAT APPLICATION WAS RETURNED IN JANUARY THIS YEAR, ESSENTIALLY REJECTED.

I URGE YOU TO CONTINUE YOUR SUPPORT OF COSBI. THE POTENTIAL FOR OUR INDUSTRY IS ENORMOUS, BUT ITS DEMISE IS NOT IMPROBABLE. THIS MAY

VERY WELL BE THE LAST OPPORTUNITY I WILL HAVE TO DISCUSS OUR INDUSTRY WITH THIS COMMITTEE BECAUSE BY FEBRUARY OF NEXT YEAR, I MAY VERY WELL HAVE VOLUNTARILY TURNED MY LICENSE BACK TO THE SBA.

THAT WIDGET COMPANY LOOKS BETTER ALL THE TIME.

THANK YOU FOR THE OPPORTUNITY TO SHARE THESE COMMENTS WITH YOU.

Answers to Questions
from Senators Bumpers and Weicker
February 24, 1988, Hearing Record

Question #1. - In light of the lower projections of COSBI's financial status that would result if the purchase of the SBIC debenture portfolio from the FFB were to be made without recourse, would you be willing to accept the COSBI proposal if the purchase were to be without recourse, as opposed to recourse as provided in this bill?

Would COSBI be able to survive with the lesser amount of its asset base that a without-recourse sale would provide?

Answer - As we noted in our testimony, the decision to sell the portfolio with or without recourse is a policy question for the Congress. The industry is essentially indifferent as to whether the sale is made on a recourse or non-recourse basis. We would point out, however, that a non-recourse sale would cause a substantial discount in the market value of those assets and would require a restructured sale at a substantial decrease in the purchase price.

The option of a non-recourse sale has been explored with our investment advisors and Arthur Andersen. Since the value of the assets would be reduced under a non-recourse purchase, there would also be a commensurate reduction in the amount of debt COSBI would have to issue to purchase the assets. Consequently, based on models that have been developed to take into consideration relevant financial aspects of this alternative, we have concluded that COSBI would remain a viable entity with a properly structured non-recourse purchase of the FFB portfolio.

Question #2. - With the government "on-the-line", so to speak, as guarantor of the FFB's $700 plus million SBIC debenture portfolio to be purchased by COSBI, as provider of the $500 million Treasury backstop, and as holder of $200 million in COSBI preferred stock, how does the management of COSBI intend to assure that the government's investment is protected?

The government's investment in COSBI, then, is around $1.5 billion or more and the industry's investment in COSBI amounts only to $20 million received from individual SBIC's.

Does that represent a fair government/SBIC investment ratio in COSBI? Is the program worth the risk to the government? Doesn't that ratio justify this Committee in asserting that SBA should have rulemaking power?

Answer - These questions are all based on the premise that COSBI will cost the government some $1.5 billion, while the SBIC industry will only have some $20 million at risk in the enterprise.

We believe the premise is incorrect. SBA's static analysis does not accurately reflect what is truly "at risk" for either party, and it fails to recognize the enormous benefits COSBI will produce. (It is a "red herring," so to speak.)

An accurate balance sheet reflecting the true costs and benefits of COSBI reveals the following:

The Industry's Costs (Risk):

A look at all the facts clearly shows that the industry has far more at risk than the government, and far more at stake in assuring that COSBI works both financially and in full compliance with the letter and spirit of the law. These risks include:

1. Each individual SBIC has anywhere from $1.0 million to $130 million in private capital at risk before the government has any financial exposure whatsoever. This SBIC capital acts as a reserve for losses which protects the government's exposure to risk. The government's position as a guarantor, provider of a backstop and holder of preferred stock are all subordinated to the SBIC's risk of loss. The industry's self-interest in protecting its own capital will automatically protect the government's investment.

2. On day one, the SBIC industry will have a total of over $1.5 billion in private capital (real dollars) at risk under COSBI. And, this capital at risk will continue to grow over time as the government's limited exposure continues to shrink. As noted above, the industry's risk of losing this capital is effectively senior to the government's risk of loss.

3. Industry executives also expose themselves to the very real risk of serious injury to their business reputations and character should COSBI fail. Although not quantifiable in dollar terms, this is a major risk for the industry.

4. Finally, the industry runs the ultimate risk that the program would self-destruct if COSBI is not successful. This will be a compelling incentive to assure COSBI will be a successful, soundly managed enterprise.

The Government's Costs (Risk)

The government's investment, in real dollars, is minimal when compared to the industry's investment, and well worth the limited risk.

1. The government will be paid a full market value price for the $700 million plus portfolio of FFB debentures. The government will receive $378 million in cash, preferred stock with a value of $200 million and warrants worth $20 million.

Regarding SBA's position as guarantor, it is quite misleading to suggest that the government, under a recourse scenario, will have to pay off on 100% of its guarantee. Except for one factor, the government's true risk of loss for loans that SBA (not COSBI) put on the books, will remain exactly the same as it is today with FFB holding the debentures on a fully guaranteed basis. The major difference will be COSBI's management of those assets. We firmly believe COSBI will manage those assets far better than the government, and as a result the actual losses to the government on its guarantee will be materially reduced.

2. It is incorrect to characterize the Treasury backstop of $500 million as a cost to the government. The backstop is a last-recourse failsafe should COSBI's financial condition become severly impaired; backstops of other government sponsored enterprises have never been used; and we are confident its use would never be necessary for COSBI. It is not an open-ended line of credit; COSBI cannot unilaterally draw down funds from the Treasury. The Secretary of the Treasury must first determine that its use is essential, and then he must go to Congress for the funds. Congress has the final say - it must pass an appropriations bill before government funds can be used.

3. The $200 million of preferred stock is a good investment, not a cost or give-away. It does not require an appropriation of funds. It will pay dividends of $50 million. It's offset by new tax revenues of $40 million from COSBI. It provides the government with substantial upside value through warrants worth a minimum of $20 million, and probably substantially more. And, finally, the preferred can be redeemed by COSBI at full value when COSBI has generated sufficient earnings to repurchase the stock.

Benefits Produced by COSBI

In addition to the dividends, tax revenues and other income noted above, COSBI will also produce substantial budget savings and a stream of other major benefits.

Budget Savings - COSBI will generate the following budget savings over the next fifteen years (using the period of time reflected in the financial models):

1. Savings of $540 million be ending direct appropriations for the MESBIC program.

2. Removal of $3.5 billion of contingent liabilities from the government's books by ending the guarantee of SBIC debentures.

3. Savings of $408 million by eliminating direct appropriations for the loss reserve on SBIC debentures guaranteed by SBA.

4. Savings of $60 million in costs no longer need for SBA's administration of the SBIC and MESBIC programs.

Economic Benefits - We also estimate, over the same time frame, that COSBI will produce the following important benefits for the economy:

1. $21 billion will be invested in small business.

2. Over 105,000 small growth firms will be financed.

3. 3.2 million new jobs will be created.

4. The government will receive $540 million in new tax revenues from SBICs.

5. The companies financed by SBICs will pay $5.3 billion in new federal taxes.

6. The employees of these small firms will pay $16.3 billion in new federal taxes.

Protection of the Government's Investment

As noted above, the industry is at risk before the government - the government will lose only if the industry loses first. The industry's exposure to risk will effectively force COSBI's management to exercise sound business judgement to assure the safety and soundness of COSBI as a viable financial institution. This provides built-in security which will automatically protect the government's position.

Moreover, the involvement of industry executives in COSBI's management will provide business discipline and several other key advantages a government agency can't replicate. For example:

1. Industry executives know their industry and have a much better understanding of how SBICs conduct business.

2. Industry executives are experts in the areas of due diligence, risk analysis and portfolio company valuation.

3. COSBI will have the capacity to establish a sophisticated "early warning" system to discover financial problems, and the resources to act on those problems much more quickly than a government bureaucracy.

Rulemaking Authority

As described above, the industry has far more at risk than does the government. In light of these facts, the proposal to give SBA rulemaking authority, or "the ability to run the business," is virtually impossible for the industry to accept. If SBA was granted the authority to run COSBI, it would only be a major disincentive to SBIC participation in COSBI; no SBICs would invest in the new enterprise; and COSBI would never become operational. This result would be a tremendous loss of opportunity - for small business, for capital formation and for the government.

At the same time, we believe the regulatory structure contained in S. 1929, absent SBA rulemaking authority, provides a comprehensive, but balanced, mix of statutory, government agency and industry responsibilities. The government retains strong "watchdog" powers through numerous oversight, audit and reporting requirements. These features are built into the system to assure the "public policy" objectives of the legislation are met. (See Exhibit VI of the prepared testimony which details the extensive regulatory and oversight authority of the Federal government over COSBI.) Moreover, because COSBI is a Congressionally chartered enterprise, Congress retains the ultimate power to intervene: to modify the charter, increase the government's control, or completely close down COSBI's operations.

Question #3. How will COSBI's oversight of individual SBICs compare to that now provided by SBA: i.e., will COSBI's management be tougher, for instance, on licensing requirements for new SBICs, or on handling troubled SBICs in need of liquidation?

Isn't it necessarily true that SBA, as a government agency, can be more patient or lenient with SBICs that have trouble meeting regular payments on debentures than COSBI can be, as a for-profit corporation?

Answer - One of the major reasons the SBIC industry is supporting the creation of COSBI is their desire to establish a system under which sound business principles will be applied to their operations in a fair and consistent manner. The basic issue is not COSBI's toughness or leniency in dealing with SBICs. Rather, the fundamental point is that SBICs are willing to invest in COSBI, and assume substantial risk in the process, in order to achieve certainty and reliability in the "rules of the road."

It is important to understand that COSBI's for-profit status will be balanced by the fact that COSBI will function as a service corporation for the industry. Profitablility, coupled with safety and soundness of the institution, will be a primary objective, but not to the point that maximization of profits would be harmful to the industry.

The success of SBICs and COSBI will be mutually interdependent. It will be in both the industry's and COSBI's mutual best interests to establish sound licensing standards based on business principles, to encourage entry into the program by qualified parties, and to promote responsible expansion of the program.

COSBI's management will bring this important element of business discipline to the process; a feature which cannot be replicated by a government bureaucracy. These business disciplines are essential to establish a path of growth and expansion for the program. SBICs are not seeking soft, lenient treatment at the bosom of SBA, as if SBA were some social agency. Just the opposite is true; SBICs are asking for a reliable system based on sound business principles. They are attempting to extricate themselves from an unresponsive, unreliable and arbitrary process that changes without warning and completely lacks business discipline - a system that is slowly destroying the program.

Question #4. - The Inspector General of SBA has recently requested of this Committee that we change the current law requiring annual audits of all SBICs to allow either biannual audits or an abbreviated audit procedure for those SBICs which are well-managed. If that change in the law were made today, would it reduce or remove the need for legislation creating COSBI.

Answer - The short answer is "no." As previously indicated, the industry's desire to establish COSBI is based on a need to make fundamental changes in the process that will assure a stable source of funding and a reliable operating environment for the industry. Once implemented, these fundamental changes will allow the industry to expand and better serve small business.

While in no way attempting to diminish its value, the Inspector General's proposal (which we support) is simply a procedural improvement; one small change in a larger process that is badly flawed. However, this singular improvement does not address the fundamental changes COSBI would provide.

We would also note that the Inspector General's proposal parallels the audit frequency proposed in the COSBI legislation. In addition, we are quite confident the complete audit process will be managed far more efficiently under COSBI.

Question #5. - Why is the SBIC industry in Arkansas practically dead, and is that also the situation in other states? (Arkansas had 4 SBICs plus 2 MESBICs until last year, when the Worthen Bank SBIC surrendered its license, and only two of the remaining SBICs are active, barely at that.) Why is it that the SBIC industry is not stronger in these states, especially when the SBIC law provides for an override of the state usery limits?

Answer - This is a difficult question to answer without having detailed information relating to a number of economic factors which have a bearing on the capital formation process within a particular state. These include, for example, personal and corporate savings rates, institutional investor preferences, structural barriers to investment, infrastructure and human resource advantages, tax environment, and market restrictions which may affect investment opportunities.

At the same time, we would suggest that the decline in the number of licensed SBICs in any areas of the country undoubtedly has much to do with the turmoil under which the SBIC program has had to operate in the last few years. As we noted at the hearing, from 1985, when the Adminstration first put the SBIC program on the "chopping block," through 1987, active SBIC licensees suffered a net decrease from 391 to 307 companies - a 21%

reduction in total licensees in just three years. The impact of the threat of extinction under which the program participants have had to operate has obviously first been felt in areas where the operations and economies of SBICs are more immediately susceptible to such traumatic policy disruptions. It is unfortunate, but not surprising, that less established SBICs have been more likely to leave the program and "cut their losses." Nor is it surprising that there are few willing applicants to fill the void irrespective of the benefits provided by the override of a state usury limit.

When certainty is brought into the program through the enactment of COSBI, we anticipate substantial growth in the indusrty, which will make hundreds of millions of dollars of new seed and venture capital available to small businesses. The real beneficiaries of COSBI will be the small businesses in Arkansas and every region in the country.

Question #6. - In your testimony, you state that the $500 million Treasury backstop proposed in this bill would be the lowest backstop of any government-sponsored enterprise. Would the size of this backstop have any effect on the marketability of COSBI securities as compared to other government "agency" paper?

Answer - The investment bankers with whom we have worked have advised that a backstop of $500 million, when coupled with COSBI's other "agency" characteristics, is sufficient to assure that COSBI's securities can be marketed on a basis comparable to other agency paper.

Question #7. - According to the Small Business Administration, about one-third of all licensed SBICs, with private capital of $550 million, or 39 percent of the program's total private capital, do not use SBA leverage. Do you have any indications that those SBICs will join COSBI and whether they will seek leverage funds once COSBI is established?

Answer - Based on surveys of the industry, regional and national meetings, and a special meeting last year with this specific group of SBICs, we have every reason to believe they support and will join COSBI. Leverage through the COSBI system will be available to these SBICs on the same terms and conditions as all other SBICs. We have no specific indications whether the individual policies of these SBICs regarding the use of leverage will change once COSBI becomes operational.

Question #8. - The bill provides that from the proceeds of the sale of the SBIC portfolio the government would purchase preferred stock in COSBI. After two years COSBI would be required to pay dividends of 5 percent on profits over $2 million each year. Furthermore, COSBI will issue to the government warrants which will enable the government to purchase COSBI non-voting stock. These provisions enhance the financial condition of the bank and allow the government to share in any up-side of COSBI operations. Do you support these provisions of the bill? How would you respond to the contention that the warrants would be "worthless?"

Answer - We support these provisions of the bill. Based on the financial projections of COSBI's operations submitted to the Committee at the hearing, and attested to by Arthur Andersen & Co. as reasonable, the warrants would give the government an upside profit of about $20 million. If COSBI were to do substantially better than these very conservative projections, the value of the government's warrants would increase accordingly. For example, if COSBI's stock were to go public at some time in the future, like Fannie Mae and Sallie Mae, the value of the government's warrants could increase by a substantial multiple of what is currently projected.

Answers To Questions From
Senator Dixon
February 24, 1988 Hearing Record

Question #1. - Has any SBIC been denied access to capital because of lack of available funds from SBA? If so, when did that occur?

If possible, please give a history of all denials by year.

Answer - Both regular SBICs and MESBICs have been denied access to funding on several occasions throughout the history of the program.

Regular SBICs, for example, had no funding at all during several of the first 15 years of the program because the Administration failed to release funds or Congress did not appropriate funds. In 1981, there was a five-month period during which absolutely no leverage was available to regular SBICs, and when funds did become available, SBA imposed an artificial $1.0 million cap on leverage applications. In 1982, the Administration tried to cut the regular SBIC leverage authorization from $160 million to $125 million. In 1983, no leverage was available for a two-month period. When funding was made available, 41 SBICs applied for $113 million, but there was only $19 million to meet that demand for funds. In 1984 and 1985, SBA imposed artifical allocation restrictions on leverage applications and imposed tighter credit policies. In 1986, regular SBIC funding was taken out of the Federal Finance Bank, the SBA Administrator attempted to scuttle the new funding system authorized by Congress, and there was no access to funding for a period of six months. The new funding system for regular SBICs operated on a very sporadic basis during 1987 while SBA's restrictive allocation and credit policies continued. Now, in 1988, the Administration has proposed a 35% cut in funding for regular SBICs.

For MESBICs, the situation has been even more critical. On numerous occasions over the last five years, MESBIC funding applications have far exceeded funds available. And now the Administration has proposed that all financial incentives in the MESBIC program be eliminated, and that MESBICs be forced to secure funding on the same basis as regular SBICs. This proposal, if adopted, would simply terminate the MESBIC program.

Neither NASBIC nor NAIC have access to specific information on SBA denials of individual SBIC and MESBIC applications for leverage. That information must be obtained from SBA.

Question #2. - FNMA and Freddie Mac securities are not exempt from state and local taxation. Why is it necessary for COSBI securities to have this exemption?

Answer - Although the FNMA and Freddie Mac charter acts do not specifically provide statutory exemptions from state and local taxes, securities issued by those institutions are deemed to be "government securities" and thus exempt by law from state and local taxes.

The state and local tax exemption provision was put in the COSBI bill to assure certainty of the exemption. However, it is not absolutely essential, and, if necessary, the industry would be willing to delete the exemptive provision.

Question #3. - Is it your expectation that COSBI common stock will eventually be publicly held and/or traded?

If so, why is there a provision to require additional capital contributions from SBICs?

If not, what is the attraction to the government to own common stock? Without a secondary market into which the government could sell its shares there may not be an opportunity to realize any capital appreciation potential.

Answer - In our view, it would be a mistake to try to predetermine COSBI's long-term capital structure at this time. The bill has been crafted to give the corporation the flexibility needed to adjust to changing conditions in the capital markets.

The ability of COSBI to issue common stock in the public markets will, of course, depend on the corporation's financial performance over time. If, as we expect, COSBI performs well, we anticipate that COSBI's Board of Directors would consider the public sale of non-voting securities as one viable alternative to raise capital for growth and expansion (similar to what Sallie Mae has done). Under this scenario, the government would have a liquid market in which to sell its shares and realize capital appreciation.

The provisions providing for capital contributions by SBICs are of two forms. The first (Sec. 354(a)(4)(A)) requires that every SBIC "shall" purchase common stock equal to 1% of its private capital. The industry views this as a legitimate entry fee to do business under COSBI; it provides the corporation's inital capital base, and it reflects the industry's commitment to COSBI. The second (Sec. 354(a)(4)(B)) is a discretionary charge COSBI "may" impose. This provision gives COSBI an interim source of capital for growth until the type of performance level mentioned above is realized, and COSBI can sell stock in the public markets.

Finally, even if COSBI did not go public, the government could still realize capital appreciation by selling its stock to individual SBICs. Section 361(d) of the bill provides that the Administration can sell its common stock to an SBIC, and that SBIC can use the stock to meet its capital contribution requirement. Thus, the government would still have a market to sell its common stock, i.e. to groups forming SBICs and seeking an SBIC license.

Question #4. - Why should the government receive warrants convertible only into nonvoting common stock? Two classes of common stock would effectively prevent the government from realizing the same profit potential as other common stockholders.

Answer - Two classes of common stock would not prevent the government from realizing maximum profit potential from the warrants. Holders of both the nonvoting and voting stock will be entitled to share equally in profits; the only distinction in these securities will relate to voting rights. Sallie Mae, for example, has over 35 million outstanding shares of nonvoting common stock outstanding, and the holders of that stock have made a substantial profit.

As noted in the previous answer, at the time the government exercises its warrants, it would have the option of either selling its shares to third parties interested in the purchase of nonvoting common for investment purposes, or selling its shares to SBICs entering the program who could use that stock to satisfy their capital stock requirement with COSBI.

In addition, conversion of the government's interest into voting common would dilute the basic premise of the SBIC industry's commitment to COSBI through its assumption of risk through ownership.

Question #5. - As proposed, the government would receive $200 million of 5% preferred stock. This stock would be non-voting and non-payable unless COSBI earns at least $2 million in net income. That arrangement appears to allow common stockholders to receive a dividend even if the preferred stockholders do not. Why shouldn't the preferred stockholders be paid their dividend first, no matter what the circumstances?

Answer - The assumption for this question is incorrect. Preferred shareholders do have a preferred dividend position.

See Section 353(b)(2) of the bill which provides that "No dividends shall be payable on any share of common stock at any time when any dividend is due on any share of preferred stock and has not been paid."

Question #6. - The present limit on SBIC leverage is a 4:1 ratio of debt to equity. The proposed legislation replaces that limitation with a provision that the proportion an individual SBIC represents in outstanding obligations can be no more that 10 percent. What controls would prevent an SBIC from becoming over-leveraged?

Answer - The 10% limitation in the bill does not replace the 4:1 debt to equity ratio. Rather, it provides a new method to compute the maximum amount of leverage available to an SBIC under COSBI. As such, it replaces the fixed $35 million ceiling in current law. Defining this new ceiling in terms of a reasonable relationship to COSBI's outstanding obligations does two things: it assures a reasonable diversificaton of COSBI's risks; and it removes an artifical barrier to the formation of larger SBICs. For example, under the current artificial $35 million ceiling, there is no incentive to capitalize an SBIC that intends to use leverage at more than $9 million. The newly defined ceiling, which will increase as COSBI grows, will provide an opportunity for the creation of SBICs with larger capitalizations.

The amount of leverage provided to an SBIC within this ceiling then becomes a determination based on the financing standards established by COSBI's Board of Directors, rather than an arbitrary ratio. Because of the broad diversification in the types of SBICs, significant variations in their investment policies, and COSBI's potential to develop a variety of methods to financing those SBICs, we believe it is far more appropriate that COSBI's standards be applied to each company on a case-by-case basis. In light of the significant risk the industry has in COSBI, and the compelling incentives to assure its success, we are confident the Board would not permit the corporation's operations to be endangered by over-extending leverage to any individual SBIC.

Question #7. - There has been much discussion over the years whether the loan portfolio being held by the Federal Financing Bank should be sold to COSBI with or without recourse. Why is it necessary for COSBI to start with an initial portfolio? Did any other governmental entity begin with an existing asset base?

It appears that COSBI plans to use debentures being held by the Federal Financing Bank as an initial asset base from which to "secure" its own debenture financing in the secondary market.

However, all future SBIC debentures added to the asset base would not be guaranteed by the SBA. Shouldn't the entire portfolio consist of identically-featured debentures?

Wouldn't the initial sale of COSBI debentures provide a better indication of future market reception/pricing if the initial asset base consisted of non-guaranteed SBIC debentures?

Answer - This initial asset base, whether purchased with or without recourse, serves several purposes for COSBI. First, it gives COSBI the opportunity to gain immediate recognition and a presence in the capital markets by selling its securities to finance the purchase. Second, it provides sufficient cash flow for operating purposes to carry COSBI through its start-up and development stages until it has developed a mature portfolio of its own. (Conversely, our financial modeling has shown that starting COSBI as a free-standing corporation without this initial asset base is not feasible.) Finally, it avoids the problem of having a two-tiered system if the existing portfolio was retained by the government, i.e. SBICs with debentures still held by FFB would continue to be subject to the government's jurisdiction, as well as COSBI's.

It is our understanding that all other GSEs did, in fact, start with substantial assets or start-up capital provided by the Federal government. Although these assets were of differing types, they served the same essential purpose.

The successful issuance of COSBI's securities in the capital markets does not require that its entire portfolio consist of identically-featured debentures.

Because of its status as a government sponsored enterprise, COSBI's securities will be treated as "Agency" securities. The future market reception and pricing of its securities will not depend on the character of its initial asset base.

Question #8. - As long as the price paid by COSBI is based on market yields and reasonble default assumptions, what difference does it make to COSBI whether the loan portfolio is purchased with or without recourse?

Answer - It makes no difference. As we pointed out in our testimony, the decision to sell the portfolio with or without recourse is a policy question for the Congress. The industry is essentially indifferent as to whether the sale is made on a recourse or non-recourse basis. We would point out, however, that a non-recourse sale would cause a substantial discount in the market value of those assets and would require a restructured sale at a substantial decrease in the purchase price.

Question #9. - SBICs are venture capital firms with special market advantages imputed by the SBA license. Many do not secure leverage from SBA, but rely on private capital. Why should SBICs which have no intention of using COSBI for leverage be required to pay 1% of their private capital to retain SBIC status?

Answer - This 1% payment of private capital represents each SBIC's commitment to, and investment in, the improved future of the SBIC industry under a redesigned structure that provides business discipline and stability to the program through COSBI. Based on surveys of the industry, regional and national meetings, and a special meeting last year with the majority of SBICs that do not use leverage, we are confident every one of these SBICs will support and invest in COSBI.

In addition, we are also convinced that the value of this investment will greatly appreciate over time as the SBIC industry grows under COSBI.

Question #10. - Please give a history of the number of SBICs which entered and left the industry by year, beginning at 1980. Of the SBICs which left, how many have defaulted on their debentures? Please indicate whether the data includes or excludes MESBICs.

Answer - The following table reflects the limited aggregate information available to NASBIC on this subject. This information shows the number of active SBICs in existence on the dates noted. (MESBICs are not included.)

Date	Number of Active SBICs
12/31/79	329
12/31/80	350
12/31/81	362
12/31/82	361
12/31/83	373
12/31/84	391
12/31/85	372
12/31/86	333
12/31/87	307

Additional detailed information, including that related to defaults, must be obtained from SBA.

Senator **Weicker**. Thank you very much. Why don't we leave the questions until after Mr. Kamath has testified. Thank you very much, Mr. Jones, for your testimony.

Mr. Divakar Kamath, vice president of the Equico Capital Corp. of New York who is representing the National Association of Investment Companies.

STATEMENT OF DIVAKAR R. KAMATH, VICE PRESIDENT, EQUICO CAPITAL CORP., NEW YORK, NY, REPRESENTING THE NATIONAL ASSOCIATION OF INVESTMENT COMPANIES

Mr. **Kamath**. Thank you, Senator Weicker, and Members of the Committee. Good afternoon. I am Divakar Kamath, and I'm a VP at Equico Capital in New York, which is a MESBIC and a wholly-owned subsidiary of Equitable Life. I am chairman of the National Association of Investment Companies which represents all of the MESBICs in this country.

I have a rather lengthy written testimony here that I will not bore you with the details of, but I would like it to be included in the record.

Senator **Weicker**. It will be included in the record.

Mr. **Kamath**. Since I have been given just a few precious moments, I will try and summarize the contents therein as follows. I want to speak first of the good news, then the bad news, our solution to the bad news, discuss the MESBIC trust because Dave Jones has already discussed the essentials of COSBI, and then answer some specific questions that Chairman Bumpers requested in his letter to us.

The good news, Senator Weicker and Members of the Committee, is that our industry is a very successful program for the benefit of both minority small business and otherwise. Let me illustrate. When Equico was established in 1971, the average MESBIC investment was less than $13,000. And the industry's total investments amounted only to $2.2 million. By 1987 the majority of our investments are over $100,000, and the industry invested a total of $143 million.

Although we are looking at increasingly sophisticated businesses, we continue to maintain a strong base in the more traditional areas of retail, services, manufacturing. Communications, utilities, and transportation have also offered special opportunities to the industry and also comprise a large part of our portfolio. The industry has always invested in a large percent of start-ups, and our 9-year average between 1978 and 1986 was 46 percent. Although the number of MESBIC investments by State varies according to the minority population in each State, over the past 7 years, we have invested in all but two States.

As far as examples of our investments, they range all of the way from tortilla chips to silicon chips. In Texas, for example, one of our MESBIC's has invested in a chain of Hispanic restaurants called Ninfas. We think that they will be very successful and be acquired hopefully in the near future.

We have invested among six MESBIC's approximately $3 million in a company in Silicon Valley that makes process control instrumentation. We think the products have the ability to give the U.S.

a competitive edge in the manufacturing of silicon chips in the future.

Connection Communication is an example where we put $2½ million in a start-up for the construction of the cable system in Newark, and in 5 years it was sold for $33 million.

And of course, all of you are familiar with Reggie Lewis who recently acquired a Beatrice Food international division for $985 million. I am proud to say that Equico was involved in Reggie's first deal when he acquired McCall Patterns from Norton Simon.

The results of our investments have been beneficial not only to minority-owned small businesses, but to the individuals they employ, to the Government in the form of job creation, innovation, and tax revenues. Over the 10 year period from 1978 to 1987, we invested $750 million in approximately 8,500 firms. These companies provided job training and in some cases management training to the 118,000 employees. And the companies' estimated tax revenues as a result of 1987 investments alone were almost $136 million.

Looking at the results of just 1 year's activities, you will find that the MESBIC industry has an impressive track record. In 1987 MESBIC's received $39 million in leverage from the SBA. We, in turn, invested $143 million in the minority small business community. And typically when a MESBIC invests in a small business, banks and other more conservative funding sources will look more favorably on these companies resulting in an average of $2 investment by these sources for every $1 of ours. And thus, last year when we invested $143 million in minority small businesses, other private sources in turn invested $286 million resulting in a total of $429 million going to the minority small business community.

In summary, the Government's $39 million investment in the MESBIC industry last year alone resulted in $429 million invested in the minority small business community. These investments help to create or maintain 17,700 jobs and generated $136 million in tax revenues.

Now for the bad news. In spite of all of these successes, we think that the industry is in dire trouble for several reasons. One, the number of MESBIC's is shrinking. In 1986 alone, we saw for the first time more companies leave the industry than join. In 1987 we had 18 companies leaving and only 6 joined. That is a 3 to 1 ratio. And our private capital growth rate is shrinking as well. In 1980 our private capital grew at a rate of 27 percent. In 1987 it is down to a 1 percent growth rate. All of this does not bode well for the minority small business community.

And the reasons for these adverse conditions are very specific. One, it is an unstable regulatory environment. Two, it is insufficient funding. We had $45 million a few years ago. It is now down to $36 million and it creates a lot of problems. The Congress has been very supportive, but notwithstanding that, we found that our entire funding level is eroded every year.

To make matters worse, the Administration for the 7th year in a row is proposing to either abolish or severely diminish the MESBIC program. In fact, the latest administrative budget calls for MESBIC's to obtain funds on the terms as the regular SBIC's, but to restrict it to a very small percent of the SBIC funding pool.

The solution then is that we must find a new funding mechanism that can provide room for growth for our industry or we will continue to suffer from attrition and eventually go out of business. In these days of budget cuts and deficit reduction, it is unrealistic to believe that we can grow within the budget. We must go off budget to the capital markets.

And I think the solution then is COSBI. COSBI could save the MESBIC Program by providing funding stability through its access to the private capital markets and the MESBIC industry's special incentive would continue under the MESBIC trust.

Before actually discussing the trust, I want to assure you that we analyzed several issues that would severely impact the trust. And I want to enumerate some of these issues. We looked at how the MESBIC's could be protected as small players in such a large investment vehicle. Would MESBIC's be able to continue to get the subsidies we currently receive in recognition of our special investment policies? Would MESBICs have equal access to the corporation's financing window? Could we be assured that Wall Street would not receive our participation in the corporation negatively and reflect that in the pricing of COSBI securities? Would the cost of participation in COSBI be equitable for MESBIC's? Would MESBICs have adequate representation in the leadership of the corporation? And would the continuing Federal presence in the corporation recognize the special mission of the MESBIC industry?

We have weighed these risks, and we spent an exorbitant amount of time and money seeking answers to these questions and developing alternatives to address these concerns. The distillation of these efforts is the MESBIC trust.

The trust's framework was developed in detail by industry leadership and approved by the industry. And I can assure you that it has widespread support of our industry. In order to win their support, however, we had to prove to them the viability of the trust. We have done so with the MESBIC trust computer model that is attached to the testimony.

This model reviews the operations of the trust over its full 50-year life. It covers in detail the revenues and expenses of the trust over the 50-year period and takes into account a debenture-by-debenture analysis of the outstanding MESBIC portfolio held by the SBA. The model proves that the trust will not only sustain the industry during the next 50 years, but it will allow us to grow once again.

Having outlined the need for and the development of the MESBIC trust, I am going to briefly discuss some of its specific provisions.

Because MESBIC's are restricted to investing in minority-owned small business, they have had special incentives made available to them. In the past year, these incentives have consisted of SBA purchases of 10-year debentures from MESBIC's with a 3 percent interest rate subsidy during the first 5 years and SBA purchases of 3 percent cumulative preferred stock from the MESBIC's. These incentives will be retained under COSBI although a 10-year call feature would be added to the preferred stock. Since the 10-year call would qualify the stock as a debt instrument under the new accounting standards, MESBIC's would be offered an alternative to the preferred stock leverage in the form of longer term, deeper subsidy debentures. The new debentures would carry an interest rate subsidy of up to 4 percent for a period of 15 years.

The trust will be administered by five trustees. Three of the trustees will be nominated by MESBIC's and appointed by COSBI's board. One of the trustees will be appointed by the President, and the remaining trustee will be ex officio, the COSBI board chairman.

The corpus of the trust will be composed of the $150 million onetime funding from the sale proceeds of the SBIC portfolio, and a transfer to the trust of the existing MESBIC debentures and preferred stock currently held by SBA and not in liquidation.

Trust income would be exempt from Federal, State and local taxes. The trust funds will be used to cover losses on loans or investments to MESBIC's, provide an interest differential on MESBIC debentures, purchase MESBIC preferred stock and cover the operating costs of the trust for a period of 50 years. At the end of 50 years, the trust will be liquidated, the preferred stock redeemed, the funds will be turned over to the Treasury, and the MESBIC's will operate as regular SBIC's.

I now want to answer a few of the questions that were requested by Chairman Bumpers that we address in his letter to us. The first question is could COSBI survive in the absence of the implicit Federal support provided by the emergency backstop provisions. The purpose of the backstop is to make COSBI securities more attractive to private investors allowing the corporation to borrow at near Treasury rates. The backstop is discretionary and subject to appropriation by Congress. Although we do not anticipate that the corporation would ever need to use the backstop, our discussions with Wall Street analysts indicate that the backstop is absolutely necessary if we are to obtain reasonable rates in our public offerings. Absent the backstop, our cost of funds will become prohibitively high as would the cost of funds to the minority-owned small businesses in which we invest.

The second question was, will COSBI be able to successfully regulate by contract SBIC business practices. It is our belief that the contractual agreement between COSBI and the individual SBIC's will ensure regulatory compliance on the part of SBIC's. The corporation's power to take corrective action against companies, combined with the industry's financial incentive to ensure the viability of the corporation, serves to guarantee that regulatory violations are kept at a minimum. Any violations of regulations might affect the financial stability of the corporation, jeopardizing both our investments in the corporation and our ability to continue to raise funds from private capital markets.

How will COSBI affect the cost and availability of venture capital to small businesses? Our past experience in our industry has proven that the industry's potential for attracting large capital pools exists. By providing stability and growth in the SBIC and MESBIC industries, we expect to see a large influx not only of matching funds to the corporation, but of private funds into individual MESBIC's and SBIC's. This sharp increase in the availability of venture capital to small businesses should produce, if only through the laws of supply and demand, a lower cost of money to individual businesses.

And finally, what recommendations or changes would you suggest for the bill? We would suggest the adoption of the House language in the regulatory oversight section of the bill. We would also like to see the call on the preferred to be increased from 10 years to 15 years.

In summarizing then, I have been in the industry now for about 10 years. And since then, we have seen much better deals, more sophisticated deals and more profits in the horizon. So, one would assume that we should all be jubilant, but there is a very solemn mood in the industry. We should be really cheering and asking some of our friends and some of the major corporations to join the industry. Unfortunately, in all honesty, we cannot because the situation is so uncertain.

I think COSBI is the answer, and the ball is now in both your court and ours. Thank you.

[The prepared statement of Mr. Kamath follows:]

TESTIMONY

BY

DIVAKAR R. KAMATH

CHAIRMAN

NATIONAL ASSOCIATION

OF

INVESTMENT COMPANIES

BEFORE THE

SENATE SMALL BUSINESS COMMITTEE

FEBRUARY 24, 1988

GOOD AFTERNOON, CHAIRMAN BUMPERS AND MEMBERS OF THE SMALL BUSINESS COMMITTEE. I AM DIVAKAR KAMATH, VICE PRESIDENT OF EQUICO CAPITAL CORPORATION IN NEW YORK, AND CHAIRMAN OF THE NATIONAL ASSOCIATION OF INVESTMENT COMPANIES (NAIC).

AS VICE PRESIDENT OF EQUICO, I REPRESENT ONE OF THE LARGEST INVESTMENT COMPANIES IN THE MESBIC INDUSTRY. EQUICO CAPITAL CORPORATION IS A SUBSIDIARY OF THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES. SINCE ITS ESTABLISHMENT IN 1971, EQUICO HAS MADE INVESTMENTS IN MINORITY-OWNED SMALL BUSINESSES, BUT WE ALSO FORM SYNDICATIONS FOR LARGER INVESTMENTS AND ENABLE OUR CLIENTS TO SUPPORT FURTHER BORROWING FROM SENIOR LENDERS.

EQUICO HAS BEEN IN EXISTENCE ALMOST SINCE THE BEGINNING OF THE MESBIC PROGRAM. THE EQUITABLE, ALONG WITH SEVERAL OTHER LARGE U.S. PRIVATE INSTITUTIONS, RESPONDED TO A CALL FROM THE NIXON ADMINISTRATION TO PROVIDE FUNDS FOR INVESTMENT IN MINORITY OWNED SMALL BUSINESSES. IN TURN, THE GOVERNMENT PROVIDED MATCHING FUNDS FOR INVESTMENT, USING THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM AS A MODEL. THUS WAS BORN A PARTNERSHIP BETWEEN PRIVATE SECTOR INVESTORS AND THE FEDERAL GOVERNMENT THAT RESULTED IN THE TREMENDOUS GROWTH IN THE SIZE AND EXPERTISE OF THE MINORITY SMALL BUSINESS COMMUNITY.

OVER THE YEARS, THE MESBIC INDUSTRY HAS PROVEN TO BE A SUCCESSFUL AND COST-EFFECTIVE PROGRAM FOR ACHIEVING THE PUBLIC POLICY GOAL OF PROMOTING THE GROWTH OF THE MINORITY SMALL BUSINESS COMMUNITY. THE STRUCTURE OF THE PROGRAM ENSURES THE GOVERNMENT A MAXIMUM "BANG FOR ITS BUCK". IN ORDER TO START A MESBIC TODAY, ONE WOULD HAVE TO HAVE

AT LEAST A MILLION DOLLARS IN PRIVATE CAPITAL. AFTER OBTAINING A LICENSE, THE MESBIC WOULD HAVE TO INVEST APPROXIMATELY 65% OF ITS PRIVATE CAPITAL BEFORE IT ~~WOULD BE~~ ELIGIBLE TO APPLY FOR MATCHING FUNDS FROM THE GOVERNMENT. IN THIS WAY, THE GOVERNMENT HAS PROOF OF THE MESBIC EXECUTIVE'S COMMITMENT TO MINORITY SMALL BUSINESS FINANCING BEFORE IT INVESTS IN THE MESBIC. EVEN AFTER THE GOVERNMENT HAS FUNDED A MESBIC, ANY LOSSES SUSTAINED BY THE MESBIC COMES FROM THE PRIVATE CAPITAL INVESTMENT IN THE COMPANY FIRST. THE GOVERNMENT FACES A POTENTIAL LOSS ONLY AFTER THE PRIVATE INVESTORS HAVE LOST ALL OF THEIR CAPITAL. THIS INSURES THE MESBIC EXECUTIVES' COMMITMENT TO SOUND INVESTMENT PRINCIPALS AND PROTECTS THE GOVERNMENT INVESTMENT IN THE PROGRAM.

THE MESBIC PROGRAM IS A LEADER IN MINORITY SMALL BUSINESS DEVELOPMENT. OUR ASSISTANCE TO MINORITY-OWNED SMALL BUSINESSES ONLY BEGINS WITH OUR FINANCIAL INVESTMENTS. OUR INDUSTRY OFFERS A CADRE OF SKILLED, EXPERIENCED, AND ETHNICALLY DIVERSE INVESTORS WHO UNDERSTAND THE SPECIAL NEEDS OF MINORITY ENTREPRENEURS AND ARE WELL-EQUIPPED TO SERVE THOSE NEEDS. OUR INVESTMENT EXECUTIVES OFTEN WORK HAND-IN-HAND WITH ENTREPRENEURS ONCE WE HAVE INVESTED IN THEIR COMPANIES, OFFERING MANAGEMENT AND TECHNICAL ASSISTANCE THAT BANKS AND MOST OTHER FUNDING SOURCES WOULD NOT PROVIDE. AS A RESULT, WE HAVE HELPED TO PRODUCE NOT ONLY SUCCESSFUL MINORITY-OWNED BUSINESSES, BUT A LARGER COMMUNITY OF SKILLED AND EXPERIENCED MINORITY MANAGEMENT EXECUTIVES.

THERE IS NO BETTER WAY TO DEMONSTRATE OUR SUCCESS THAN WITH OUR NUMBERS. WHEN EQUICO WAS ESTABLISHED IN 1971, THE AVERAGE MESBIC INVESTMENT WAS LESS THAN $13,000, AND THE INDUSTRY'S TOTAL INVESTMENTS

AMOUNTED TO ONLY $2.2 MILLION. BY 1987, THE MAJORITY OF OUR INVESTMENT WERE FOR OVER $100,000, AND THE INDUSTRY INVESTED A TOTAL OF $143 MILLION.

THE FIRMS WE ASSIST ARE DIVERSE IN MANY ASPECTS. ALTHOUGH WE ARE LOOKING AT INCREASINGLY SOPHISTICATED BUSINESSES, WE CONTINUE TO MAINTAIN A STRONG BASE IN THE MORE TRADITIONAL AREAS OF RETAIL TRADE (27%) SERVICES (13%), AND MANUFACTURING (10%). COMMUNICATIONS, UTILITIES AND TRANSPORTATION HAVE OFFERED SPECIAL OPPORTUNITIES TO THE INDUSTRY, AND ALSO COMPRISE A LARGE PART OF OUR PORTFOLIOS. THE INDUSTRY HAS ALWAYS INVESTED IN A LARGE PERCENTAGE OF START-UPS, WITH A NINE-YEAR AVERAGE BETWEEN 1978 AND 1986 OF 46%. ALTHOUGH THE NUMBER OF MESBIC INVESTMENTS BY STATE VARIES ACCORDING TO THE MINORITY POPULATION IN EACH STATE, OVER THE PAST SEVEN YEARS WE HAVE INVESTED IN BUSINESSES IN ALL BUT TWO STATES.

EXAMPLES OF OUR SUCCESS STORIES INCLUDE CONNECTION COMMUNICATION CORPORATION IN NEWARK, NEW JERSEY. TEN MESBICS INVESTED IN THIS BLACK-OWNED CABLE TV FRANCHISE WHICH HAS OVER 25,000 CUSTOMERS. THE INVESTMENT, WHICH WAS SOLD AT THE END OF 1986, CREATED SUBSTANTIAL VALUE FOR THE ENTREPRENEURS AND THE MESBIC COMMUNITY, AND WAS LATER FEATURED IN A WALL STREET JOURNAL ARTICLE. XINIX, INC., A SANTA CLARA SEMICONDUCTOR INSTRUMENTATION COMPANY, HAS ALSO RECEIVED MESBIC FINANCING. THE CHINESE-AMERICAN COMPANY HAS DOUBLED ITS SALES EACH YEAR FOR THE PAST THREE YEARS, AND RECENTLY RECEIVED ORDERS FROM IBM.

IN WISCONSIN, A MILWAUKEE-BASED MESBIC WAS THE LEAD INVESTOR OF A SYNDICATION INVOLVING FOUR PRIVATE VENTURE CAPITAL FUNDS AND ONE OTHER

MESBIC WHO INVESTED $1.5 MILLION IN GRAY SOFT, A COMPUTER SOFTWARE COMPANY. GRAY SOFT WRITES SOFTWARE FOR IBM COMPATIBLE PCs TO CONTROL THE FACTORY AUTOMATION PROCESS, AND IS THE INDUSTRY LEADER WORLDWIDE. IN MICHIGAN, A MESBIC WAS AN ORIGINAL INVESTOR IN BING STEEL, A DETROIT-BASED STEEL COMPANY. THE COMPANY IS OWNED BY DAVID BING, A FORMER ALL-STAR NBA BASKETBALL PLAYER. THE COMPANY WAS ABLE TO MAKE IT THROUGH A BAD RECESSION IN THE AUTO AND STEEL INDUSTRIES LARGELY DUE TO A SPECIAL EFFORT BY GENERAL MOTORS TO HELP ITS MINORITY SUPPLIERS. BING WAS ABLE TO REPURCHASE THE MESBIC'S STOCK IN HIS COMPANY IN 1985.

A ROCHESTER-BASED MESBIC INVESTED IN NEW YORK NATIONAL BANK IN THE SOUTH BRONX. WHEN THE MESBIC INVESTED IN THE BANK IN 1980, THE BANK HAD 18 EMPLOYEES AND TOTAL ASSETS OF $7 MILLION. ALTHOUGH THE SHORT-TERM OUTLOOK FOR THE BANK WAS UNCERTAIN, THE MESBIC BELIEVED IN THE BANK'S ABILITY TO SURVIVE AND PROSPER IN THE LONGER TERM, AND WAS PARTICULARLY SENSITIVE TO THE NEED FOR A MINORITY-OWNED BANK IN THE SOUTH BRONX. TODAY, NEW YORK NATIONAL BANK HAS GROWN TO 75 EMPLOYEES AND TOTAL ASSETS OF $65 MILLION. IN ADDITION, THEY HELPED TO ESTABLISH ANOTHER MESBIC IN THE BRONX.

IN NEW JERSEY, A MESBIC PROVIDED MONEY TO AN INDIVIDUAL WHO WANTED TO BUY A TRUCK TO MOVE WELFARE FAMILIES. OVER THE YEARS, THAT SAME INDIVIDUAL HAS COME BACK TO THE MESBIC SEVERAL TIMES FOR ADDITIONAL FINANCING AND HIS COMPANY, BRANTLEY BROTHERS MOVING AND STORAGE COMPANY, IS A MULTI-MILLION DOLLAR MOVING AND STORAGE BUSINESS WITH 75 EMPLOYEES AND 38 INTERSTATE LICENSES, MOVING MAJOR CORPORATIONS.

AND IN ILLINOIS, SEVEN DIFFERENT MESBICs HAVE INVESTED IN MAECORP, INC., A HISPANIC-OWNED HAZARDOUS WASTE AND ENVIRONMENTAL CLEANUP BUSINESS. ALTHOUGH THE COMPANY IS THE SMALLEST FIRM IN ITS NICHE OF THE MARKET, IT HAS A GROWTH RATE OF ALMOST 300%, AND HAS BEEN ABLE TO PENETRATE A MARKET DOMINATED BY LARGE COMPANIES. THE COMPANY'S PROJECTED REVENUES FOR THIS YEAR ARE $18 MILLION, AND AFTER TAX PROFITS SHOULD BE $1 MILLION.

THE RESULTS OF OUR INVESTMENTS ARE BENEFICIAL NOT ONLY TO MINORITY-OWNED SMALL BUSINESSES, BUT TO THE INDIVIDUALS THEY EMPLOY, AND TO THE GOVERNMENT IN THE FORM OF JOB CREATION, INNOVATION, AND TAX REVENUE GENERATION. OVER THE TEN YEAR PERIOD FORM 1978 TO 1987, WE INVESTED $750 MILLION IN 8,468 FIRMS. THESE COMPANIES PROVIDED JOB TRAINING, AND IN SOME CASES, MANAGEMENT TRAINING, TO THEIR 118,524 EMPLOYEES. THE COMPANIES' ESTIMATED TAX REVENUES AS A RESULT OF 1987'S INVESTMENTS ALONE WERE ALMOST $136 MILLION.

LOOKING AT THE RESULTS OF JUST ONE YEAR'S ACTIVITIES, YOU WILL FIND THAT THE MESBIC INDUSTRY HAS AN IMPRESSIVE TRACK RECORD. IN 1987, MESBICs RECEIVED $39 MILLION IN LEVERAGE FROM THE SBA. WE, IN TURN, INVESTED $143 MILLION IN THE MINORITY SMALL BUSINESS COMMUNITY. TYPICALLY, WHEN A MESBIC INVESTS IN A SMALL BUSINESS, BANKS AND OTHER MORE CONSERVATIVE FUNDING SOURCES WILL LOOK MORE FAVORABLY ON THOSE COMPANIES, RESULTING IN AN AVERAGE OF $2 INVESTMENT BY THESE SOURCES FOR EVERY ONE DOLLAR WE INVEST IN THEM. THUS, LAST YEAR WHEN WE INVESTED $143 MILLION IN MINORITY OWNED SMALL BUSINESSES, OTHER PRIVATE SOURCES IN TURN INVESTED $286 MILLION IN THOSE BUSINESSES, RESULTING IN A TOTAL OF $429 MILLION GOING TO THE MINORITY SMALL

BUSINESS COMMUNITY. IN SUMMARY, THE GOVERNMENT'S $39 MILLION INVESTMENT IN THE MESBIC INDUSTRY LAST YEAR RESULTED IN $429 MILLION INVESTED IN THE MINORITY SMALL BUSINESS COMMUNITY. THESE INVESTMENTS HELPED TO CREATE OR MAINTAIN 17,666 JOBS, AND GENERATED $136 MILLION IN TAX REVENUES.

ALTHOUGH THE MESBIC INDUSTRY IS A SUCCESS BY ALMOST ANY STANDARD, WE ARE IN DANGER OF EXTINCTION UNLESS THERE ARE SIGNIFICANT CHANGES WITHIN THE INDUSTRY. AN UNSTABLE REGULATORY ENVIRONMENT, COMBINED WITH AN INSUFFICIENT FUNDING LEVEL, MADE 1986 THE FIRST YEAR IN OUR INDUSTRY'S HISTORY THAT WE ACTUALLY HAD MORE COMPANIES LEAVING THE INDUSTRY THAN ENTERING IT. WE WERE SHOCKED TO LEARN JUST A FEW DAYS AGO THAT 1987 WAS AN EVEN WORSE YEAR FOR MESBICS, WITH 18 COMPANIES LEAVING THE INDUSTRY AND ONLY 6 NEW LICENSEES ENTERING THE INDUSTRY. IN OTHER WORDS, FOR EVERY ONE COMPANY THAT ENTERS THE INDUSTRY, WE HAVE THREE COMPANIES LEAVING THE INDUSTRY. THE ESSENCE OF THE MESBIC PROGRAM HAS ALWAYS BEEN ITS INHERENT ABILITY TO ATTRACT PRIVATE CAPITAL TO THE INDUSTRY. IN 1980, OUR INDUSTRY'S PRIVATE CAPITAL GROWTH RATE WAS 27.4%. IN 1981, THAT GROWTH RATE FELL TO 11.6%; TO 9.2% IN 1982; 13% IN 1983, 8.3% IN 1984, 4.7% IN 1985 AND 1986, AND LESS THAN 1% IN 1987. SINCE 1980, THE PRIVATE CAPITAL GROWTH RATE OF OUR INDUSTRY HAS FALLEN ALMOST 27%. THAT'S A SIGNIFICANT OPPORTUNITY LOSS FOR MINORITY BUSINESS. WE FEAR THAT UNLESS DRASTIC CHANGES TAKE PLACE, THIS IS A TREND THAT WILL CONTINUE.

AND THE CHANGES I'M TALKING ABOUT ARE NOT THE TYPES THE ADMINISTRATION HAS IN MIND FOR US. AS YOU ARE NO DOUBT AWARE, THE ADMINISTRATION'S BUDGET PROPOSAL THIS YEAR CALLS FOR THE COMPLETE ELIMINA-

TION OF DIRECT FUNDING FOR MESBICS. IT IS PROPOSED THAT MESBICS GO INSTEAD TO THE SBIC FUNDING CORPORATION FOR LEVERAGE. THIS PROPOSAL ELIMINATES THE SPECIAL INCENTIVES MESBICS RECEIVE TO RESTRICT THEIR INVESTMENTS TO THE MINORITY BUSINESS COMMUNITY. IN OTHER WORDS, MESBICS ARE EXPECTED TO OBTAIN FUNDS ON THE SAME TERMS AS REGULAR SBICS, BUT TO RESTRICT THEIR INVESTMENTS TO A VERY SMALL PERCENTAGE OF THE SBIC INDUSTRY'S POTENTIAL INVESTMENT POOL. THERE ARE ONLY TWO POSSIBLE EXPLANATIONS FOR THIS PROPOSAL. EITHER THE PARTIES WHO DRAFTED THE PROPOSAL ARE IGNORANT OF THE SPECIAL FUNCTION OF THE MESBIC INDUSTRY, OR THEY ARE PURPOSELY TRYING TO ELIMINATE THE PROGRAM. PAST ADMINISTRATION PROPOSALS STRONGLY SUGGEST THE LATTER.

I REALIZE THAT THE ADMINISTRATION'S BUDGET PROPOSAL IS JUST THAT - A PROPOSAL - AND THAT IN THE PAST YOU AND OUR OTHER GOOD FRIENDS IN CONGRESS HAVE BEEN ABLE TO PROTECT US FROM THE ADMINISTRATION'S ATTEMPTS TO DISMANTLE OUR PROGRAM. WE THANK YOU WHOLEHEARTEDLY FOR YOUR SUPPORT. THE SAD TRUTH IS, HOWEVER, THAT EVEN THE FUNDING LEVELS YOU HAVE BEEN ABLE TO PRESERVE FOR US ARE INSUFFICIENT, AND CAN NOT SUPPORT OUR CONTINUED OPERATIONS.

THE MESBIC INDUSTRY HAS FACED A FUNDING SHORTAGE FOR SEVERAL YEARS NOW. AND THE SHORTAGE OF MATCHING GOVERNMENT FUNDS IS COMPOUNDED BECAUSE PRIVATE INVESTORS ARE NO LONGER WILLING TO INVEST IN THE INDUSTRY WHEN THEY DOUBT THE AVAILABILITY OF MATCHING GOVERNMENT FUNDS IN THE FUTURE. A FEW YEARS AGO, THE INDUSTRY HAD A FUNDING LEVEL OF $45 MILLION. EVEN AT THAT LEVEL, WE HAD A FUNDING APPLICATION BACKLOG AT THE SBA. SINCE THEN, WE HAVE BEEN CUT TO $36

MILLION, AND THE BACKLOG HAS BECOME EVEN MORE SEVERE. WE MUST FIND A NEW FUNDING MECHANISM THAT CAN PROVIDE ROOM FOR GROWTH FOR OUR INDUSTRY, OR WE WILL CONTINUE TO SUFFER FROM ATTRITION, AND EVENTUALLY GO OUT OF BUSINESS. IN THESE DAYS OF BUDGET CUTS AND DEFICIT REDUCTION, IT IS UNREALISTIC TO BELIEVE THAT WE CAN GROW WITHIN THE BUDGET. WE MUST GO OFF BUDGET TO THE CAPITAL MARKETS.

S. 1929 THE CORPORATION FOR SMALL BUSINESS INVESTMENT

THE CORPORATION FOR SMALL BUSINESS INVESTMENT (COSBI) WOULD ALLOW US TO DO JUST THAT. S. 1929 REPRESENTS THE CULMINATION OF EXTENSIVE WORK ON THE PART OF THE MESBIC AND SBIC INDUSTRIES, ALONG WITH THE SMALL BUSINESS COMMITTEE STAFFS, PUBLIC POLICY MAKERS, AND WALL STREET ANALYSTS. ALL OF THE PARTIES WORKED TOGETHER TO DEVELOP THE BILL. COSBI REPRESENTS THE MOST EFFECTIVE APPROACH TO COMBINED GOVERNMENT EFFORTS TO FOSTER SMALL BUSINESS DEVELOPMENT AND ITS RESULTING JOB CREATION AND INNOVATION WITH INCREASED STABILITY AND ACCESS TO PRIVATE CAPITAL.

CAPITAL STRUCTURE

THE INITIAL CAPITALIZATION OF THE CORPORATION WILL COME FROM THE SBICS AND MESBICS. IN ORDER TO DO BUSINESS WITH THE CORPORATION, EACH SBIC WILL BE REQUIRED TO PURCHASE COSBI COMMON STOCK EQUAL TO 1% OF THE SBIC'S PRIVATE CAPITAL, PLUS 1% OF THE LEVERAGE THE SBIC HAS RECEIVED. PARTICIPATION IN THE INITIAL STOCK OFFERING IS MANDATORY FOR ALL COMPANIES WISHING TO CONTINUE TO DO BUSINESS. THOSE SBICS NOT WISHING TO PARTICIPATE IN COSBI WILL BE PHASED OUT. THE SBA WILL

WRITE REGULATIONS TO COVER THE PHASE-OUT OF THESE COMPANIES, AND WILL CONTRACT WITH COSBI TO ADMINISTER THE REGULATIONS.

IN ADDITION TO THE INITIAL CAPITALIZATION OF THE CORPORATION, COSBI MAY CALL ON SBICS FOR ADDITIONAL CAPITAL WHEN NEEDED. COSBI MAY REQUIRE EACH SBIC TO MAKE A CAPITAL CONTRIBUTION TO THE CORPORATION NOT TO EXCEED 1% OF ANY INCREASES IN ITS PRIVATE CAPITAL AND 1% OF THE UNPAID PRINCIPAL BALANCE OF ANY LEVERAGE THE SBIC RECEIVES THROUGH COSBI.

COSBI, AS A GOVERNMENT SPONSORED ENTERPRISE (GSE), WILL HAVE A $500 MILLION TREASURY BACKSTOP. THE PURPOSE OF THE BACKSTOP IS TO MAKE COSBI SECURITIES MORE ATTRACTIVE TO PRIVATE INVESTORS, ALLOWING THE CORPORATION TO BORROW AT NEAR-TREASURY RATES. THE BACKSTOP IS DISCRETIONARY, AND SUBJECT TO APPROPRIATION BY CONGRESS. ALTHOUGH WE DO NOT ANTICIPATE THAT THE CORPORATION WOULD EVER NEED TO USE THE BACKSTOP, OUR DISCUSSIONS WITH WALL STREET ANALYSTS INDICATE THAT THE BACKSTOP IS ABSOLUTELY NECESSARY IF WE ARE TO OBTAIN REASONABLE RATES IN OUR PUBLIC OFFERINGS. ABSENT THE BACKSTOP, OUR COST OF FUNDS WOULD BECOME PROHIBITIVELY HIGH, AS WOULD THE COST OF FUNDS TO THE MINORITY OWNED SMALL BUSINESSES IN WHICH WE INVEST.

ON OCTOBER 1, 1988, COSBI WILL PURCHASE FROM THE FEDERAL FINANCING BANK THE EXISTING PORTFOLIO OF SBIC DEBENTURES. THE PURCHASE WILL OCCUR ON A RECOURSE BASIS, WITH THE GOVERNMENT RESPONSIBLE FOR ANY DEFAULTS ON THE LOAN PORTFOLIO. THE PRICE OF THE PORTFOLIO WILL BE NEGOTIATED BETWEEN THE CORPORATION AND THE TREASURY, BUT WILL BE A MINIMUM OF $720 MILLION, WITH $200 MILLION IN PREFERRED STOCK. $150

MILLION OF THE SALE PROCEEDS WILL BE TRANSFERRED TO THE MESBIC TRUST WITHIN THE CORPORATION TO CONTINUE THEIR SPECIAL INCENTIVES FOR INVESTING IN MINORITY OWNED SMALL BUSINESSES.

IN ADDITION TO THE CASH AND PREFERRED STOCK COSBI ISSUES TO THE GOVERNMENT FOR THE SBIC DEBENTURE PORTFOLIO, THE CORPORATION WILL ALSO ISSUE TO THE GOVERNMENT WARRANTS WORTH 28% INTEREST IN NONVOTING STOCK IN COSBI. THE WARRANTS WILL ENABLE THE GOVERNMENT TO PURCHASE 28% INTEREST IN THE CORPORATION AT A FIXED PRICE FOR A PERIOD OF 15 YEARS. THE PURCHASE WILL BE FIXED ON THE DATE OF THE INITIAL CAPITALIZATION OF THE CORPORATION, AND WILL REPRESENT A PREMIUM OF 50% ON THE STOCK PRICE ON THAT DATE. FOR EXAMPLE, IF THE COSBI STOCK PRICE IS $10 A SHARE ON DAY 1, THE GOVERNMENT HAS THE ABILITY TO PURCHASE COSBI STOCK FOR A PERIOD OF 15 YEARS AT A PRICE OF $15 A SHARE, IN AN AMOUNT UP TO A 28% INTEREST IN THE CORPORATION.

THE DIVIDEND POLICY OF THE CORPORATION IS PARTIALLY MANDATED BY LEGISLATION, AND PARTIALLY SUBJECT TO BOARD AUTHORIZATION. TO THE EXTENT COSBI HAS AFTER-TAX PROFITS EXCEEDING $2 MILLION AFTER ITS FIRST TWO YEARS OF OPERATIONS, IT MUST PAY THE GOVERNMENT 5% DIVIDENDS ON ITS PREFERRED STOCK. DIVIDEND PAYMENTS TO OTHER HOLDERS OF COSBI STOCK WILL BE SUBJECT TO BOARD AUTHORIZATION.

ORGANIZATION AND MANAGEMENT

COSBI'S BOARD OF DIRECTORS WILL CONSIST OF 15 PERSONS. NINE OF THE BOARD MEMBERS WILL BE ELECTED BY STOCKHOLDERS THROUGH CUMULATIVE VOTING RIGHTS. FIVE OF THE MEMBERS WILL BE APPOINTED BY THE PRESI-

VOTING RIGHTS. FIVE OF THE MEMBERS WILL BE APPOINTED BY THE PRESIDENT. THE REMAINING BOARD MEMBER WILL BE SELECTED FROM THE MESBIC INDUSTRY. THE BOARD WILL HAVE SEVERAL POWERS, INCLUDING RESPONSIBILITY FOR BUSINESS OPERATIONS, INVESTMENT POLICIES, INTERNAL CONTROLS, STAFFING, COMPENSATION, AND OTHER AREAS.

MESBIC TRUST

AS THE CONCEPT OF A GOVERNMENT SPONSORED ENTERPRISE FOR SBICS WAS BEING DEVELOPED, THE MESBIC INDUSTRY PUT A LOT OF TIME AND RESOURCES INTO STUDYING THE IMPLICATIONS OF OUR PARTICIPATION IN THE CORPORATION. THERE WAS NO DOUBT THAT WE NEEDED ACCESS TO A STABLE FUNDING SOURCE THAT OFFERED THE POTENTIAL FOR INDUSTRY GROWTH, BUT OUR SPECIAL INCENTIVES OFFERED A PROBLEM WITHIN THE NORMAL FRAMEWORK OF A GSE. WE HELD SEVERAL INDUSTRY AND LEADERSHIP MEETINGS ON THIS PROBLEM, AND EVENTUALLY DEVELOPED THE CONCEPT OF A TRUST WITHIN THE CORPORATION THAT WOULD CONTINUE TO PROVIDE THE SPECIAL INCENTIVES FOR MESBICS. THE TRUST'S FRAMEWORK WAS DEVELOPED IN DETAIL BY THE INDUSTRY LEADERSHIP, AND APPROVED BY THE INDUSTRY. WE HAVE GONE OUT TO THE INDUSTRY IN A SERIES OF MEETINGS EACH YEAR TO DISCUSS THE PROVISIONS OF THE TRUST, AND I CAN ASSURE YOU IT HAS THE WIDESPREAD SUPPORT OF OUR INDUSTRY.

IN ORDER TO WIN THEIR SUPPORT, HOWEVER, WE HAD TO PROVE TO THEM THE VIABILITY OF THE TRUST. WE HAVE DONE SO WITH THE MESBIC TRUST COMPUTER MODEL I HAVE ATTACHED TO MY TESTIMONY. THIS MODEL REVIEWS THE OPERATIONS OF THE TRUST OVER ITS FULL 50 YEAR LIFE. IT COVERS IN

DETAIL THE REVENUES AND EXPENSES OF THE TRUST OVER THE 50 YEAR PERIOD, AND TAKES INTO ACCOUNT A DEBENTURE-BY-DEBENTURE ANALYSIS OF THE OUTSTANDING MESBIC PORTFOLIO HELD BY THE SBA. THE MODEL PROVES THAT THE TRUST WILL NOT ONLY SUSTAIN THE INDUSTRY DURING THE NEXT 50 YEARS, BUT IT WILL ALLOW US TO GROW ONCE AGAIN.

HAVING OUTLINED THE NEED FOR - AND DEVELOPMENT OF - THE MESBIC TRUST, I WOULD LIKE TO NOW DISCUSS SOME OF ITS SPECIFIC PROVISIONS.

BECAUSE MESBICs ARE RESTRICTED TO INVESTING IN MINORITY OWNED SMALL BUSINESSES, THEY HAVE HAD SPECIAL INCENTIVES MADE AVAILABLE TO THEM. IN THE PAST, THESE INCENTIVES HAVE CONSISTED OF SBA PURCHASES OF 10 YEAR DEBENTURES FROM MESBICs, WITH A 3% INTEREST RATE SUBSIDY DURING THE FIRST FIVE YEARS, AND SBA PURCHASES OF 3% CUMULATIVE PREFERRED STOCK FROM MESBICs. THESE INCENTIVES WOULD BE RETAINED UNDER COSBI, ALTHOUGH A 10-YEAR CALL FEATURE WOULD BE ADDED TO THE PREFERRED STOCK. SINCE THE 10-YEAR CALL FEATURE WOULD QUALIFY THE STOCK AS A DEBT INSTRUMENT UNDER THE NEW ACCOUNTING STANDARDS, MESBICs WOULD BE OFFERED AN ALTERNATIVE TO THE PREFERRED STOCK LEVERAGE IN THE FORM OF LONGER-TERM, DEEPER SUBSIDY DEBENTURES. THE NEW DEBENTURES WOULD CARRY AN INTEREST RATE SUBSIDY OF UP TO 4% FOR A PERIOD OF 15 YEARS.

THE TRUST WILL BE ADMINISTERED BY FIVE TRUSTEES. THREE OF THE TRUSTEES WILL BE NOMINATED BY MESBICs AND APPOINTED BY COSBI'S BOARD. ONE OF THE TRUSTEES WILL BE APPOINTED [illegible] THE PRESIDENT, AND THE REMAINING TRUSTEE WILL BE, EX-OFFICIO, THE COSBI BOARD CHAIRMAN. THE

CORPUS OF THE TRUST WILL BE COMPOSED OF THE $150 MILLION ONE-TIME FUNDING FROM THE SALE PROCEEDS OF THE SBIC PORTFOLIO, AND A TRANSFER TO THE TRUST OF THE EXISTING MESBIC DEBENTURES AND PREFERRED STOCK CURRENTLY HELD BY SBA AND NOT IN LIQUIDATION. TRUST INCOME WOULD BE EXEMPT FROM FEDERAL, STATE, AND LOCAL TAXES. THE TRUST FUNDS WILL BE USED TO COVER LOSSES ON LOANS OR INVESTMENTS TO MESBICS, PROVIDE AN INTEREST DIFFERENTIAL ON MESBIC DEBENTURES, PURCHASE MESBIC PREFERRED STOCK, AND COVER THE OPERATING COSTS OF THE TRUST FOR A PERIOD OF 50 YEARS. AT THE END OF 50 YEARS, THE TRUST WILL BE LIQUIDATED, THE PREFERRED STOCK REDEEMED, THE FUNDS WILL BE TURNED OVER TO THE TREASURY, AND MESBICS WILL OPERATE AS REGULAR SBICS.

SBIC AND MESBIC BUSINESS PRACTICES

IN ORDER TO QUALIFY TO DO BUSINESS WITH COSBI, AN SBIC MUST MEET CERTAIN REQUIREMENTS. THE REQUIREMENTS INCLUDE CURRENT GENERAL CRITERIA FOR SBICS, INCLUDING CRITERIA REGARDING THE BUSINESS REPUTATION AND CHARACTER OF OWNERS AND MANAGERS AND THE PROBABILITY OF SUCCESS, INCLUDING PROFITABILITY AND FINANCIAL SOUNDNESS. EACH NEW SBIC AND MESBIC MUST HAVE PRIVATE CAPITAL OF NOT LESS THAN $1 MILLION TO PARTICIPATE, ALTHOUGH EXISTING LICENSEES WITH LESS THAN THAT AMOUNT WILL BE GRANDFATHERED IN, ASSUMING THEY ARE IN GOOD STANDING, THEY BUY THE REQUIRED AMOUNT OF STOCK IN THE CORPORATION, THEY CONTRACT TO BE REGULATED BY COSBI, AND THEY AUTHORIZE SBA TO RELEASE THEIR RECORDS TO COSBI. S. 1929 ALSO CODIFIES THE EXEMPTION IN THE 1958 SMALL BUSINESS INVESTMENT ACT WHICH AUTHORIZES BANKS TO OWN SBICS, UP TO 5% OF THEIR CAPITAL AND SURPLUS.

IN ITS CONTRACTS WITH SBICS, COSBI WILL REQUIRE SBICS TO BE AUDITED ANNUALLY BY AN INDEPENDENT CERTIFIED OR LICENSED PUBLIC ACCOUNTANT. THE CONTRACT WILL ALSO REQUIRE BIANNUAL COMPLIANCE AUDITS BY AN INDEPENDENT OR LICENSED PUBLIC ACCOUNTANT, OR BY EMPLOYEES OR AGENTS OF COSBI, AS DETERMINED BY COSBI. SBICS MUST ALSO MAKE SUCH OTHER REPORTS TO COSBI AS COSBI REQUIRES. THE CORPORATION WILL ADOPT APPROPRIATE MEASURES TO ASSURE COMPLIANCE WITH THE ACT, AND WILL HAVE BROAD AUTHORITY TO TAKE CORRECTIVE ACTION (E.G. SUSPENSION OF OFFICERS OR DIRECTORS, ASSESSMENT OF PENALTIES AND LOSS OF QUALIFICATION) IF AN SBIC FAILS TO COMPLY WITH COSBI'S RULES AND REGULATIONS. COSBI IS AUTHORIZED TO REFER VIOLATIONS OF LAW TO THE U.S. ATTORNEY.

IT IS OUR BELIEF THAT THESE CONTRACTUAL AGREEMENTS BETWEEN COSBI AND INDIVIDUAL SBICS WILL ENSURE REGULATORY COMPLIANCE ON THE PART OF SBICS. THE CORPORATION'S POWERS TO TAKE CORRECTIVE ACTION AGAINST COMPANIES, COMBINED WITH THE INDUSTRY'S FINANCIAL INCENTIVE TO ENSURE THE VIABILITY OF THE CORPORATION, SERVE TO GUARANTEE THAT REGULATORY VIOLATIONS ARE KEPT AT A MINIMUM. ANY VIOLATIONS OF REGULATIONS MIGHT AFFECT THE FINANCIAL STABILITY OF THE CORPORATION, JEOPARDIZING BOTH OUR INVESTMENTS IN THE CORPORATION AND OUR ABILITY TO CONTINUE TO RAISE FUNDS FROM PRIVATE CAPITAL MARKETS.

S. 1929 CODIFIES THE MOST SIGNIFICANT OF THE CURRENT SBIC REGULATIONS. THESE REGULATIONS INCLUDE THE PROHIBITION OF INVESTMENTS RESULTING IN A CONFLICT OF INTEREST, OR IN THE SBIC'S CONTROL OF A SMALL

BUSINESS CONCERN. THE CURRENT MINIMUM PERIOD OF FINANCING IS RETAINED, AS WELL AS THE CURRENT OVERLINE LIMITATION. (SBIC INVESTMENTS IN SMALL BUSINESSES MUST BE FOR A MINIMUM PERIOD OF FIVE YEARS, AND AN SBIC'S INVESTMENT IN ANY SINGLE COMPANY MUST NOT EXCEED 20 PERCENT OF ITS PRIVATE CAPITAL. MESBIC INVESTMENTS MUST BE FOR AT LEAST FOUR YEARS, WITH ITS INTEREST IN ANY SINGLE COMPANY NOT EXCEEDING 30 PERCENT OF PRIVATE CAPITAL). SBIC INVESTMENTS ARE RESTRICTED TO QUALIFIED SMALL BUSINESSES. FINALLY, THE BILL PROHIBITS ANY SINGLE SBIC FROM RECEIVING LEVERAGE IN EXCESS OF 10% OF THE CORPORATION'S ASSETS.

OVERSIGHT OF COSBI

IN ORDER TO PROTECT THE GOVERNMENT'S INTEREST IN THE CORPORATION, S. 1929 ADOPTS SEVERAL GOVERNMENT OVERSIGHT PROVISIONS. THE SMALL BUSINESS ADMINISTRATION HAS REVIEW AUTHORITY OVER COSBI. THE SBA MAY EXAMINE ALL OF THE BOOKS AND RECORDS OF COSBI AND MAY REQUIRE COSBI TO MAKE REPORTS SBA DEEMS APPROPRIATE. THE SBA MUST REPORT TO CONGRESS ON ITS REVIEWS BY JANUARY 31 OF EACH YEAR. IN ADDITION, COSBI'S BOOKS SHALL BE AUDITED ANNUALLY BY AN INDEPENDENT CPA. THE AUDIT REPORT SHALL BE FURNISHED TO THE SECRETARY OF THE TREASURY, WHO SHALL HAVE ACCESS TO COSBI'S BOOKS. THE SECRETARY OF THE TREASURY WILL DELIVER AN ANNUAL AUDIT REPORT TO THE PRESIDENT AND CONGRESS, WITH RECOMMENDATIONS AND ANY INDICATIONS OF CAPITAL IMPAIRMENT. COSBI ALSO MUST SUBMIT AN ANNUAL REPORT TO THE PRESIDENT, THE SMALL BUSINESS COMMITTEES, AND THE SBA.

COSBI is subject to audit by GAO at the request of either Small Business Committee at any time. GAO is also required to submit a report to Congress on the impact of COSBI by January 21, 1993.

The books and records of the Corporation shall be subject to audit by the Office of the Inspector General of the SBA. Individual SBICs and MESBICs shall be subject to audit only if the Inspector General has reasonable cause to believe that there has been a regulatory violation or has probable cause to believe that an SBIC has committed civil fraud or has committed a violation of a Federal statute making such conduct an offense punishable by a fine or imprisonment, or both.

In S. 1929, unlike its House companion bill, the Administration is authorized to continue to make rules and regulations governing the SBIC and MESBIC industries. When the SBA proposed new rules or regulations, S. 1929 would require hearings on the proposal before an administrative law judge, with both the industry and the SBA given the opportunity to testify.

The MESBIC industry objects to this provision for two reasions. First, the SBA has a record of erratic and unstable regulation of the industry. The unstable regulatory environment makes it extremely difficult for our executives to make the type of long-term investment decisions that are the essence of our business. In 1981, we had an

DECISIONS THAT ARE THE ESSENCE OF OUR BUSINESS. IN 1981, WE HAD AN SBA ADMINISTRATOR WHO PLACED A COMPLETE MORATORIUM ON LICENSING TO LEARN MORE ABOUT THE INDUSTRY BEFORE PROMOTING ITS FURTHER GROWTH. AT THE SAME TIME, HE REFUSED TO MEET WITH INDUSTRY REPRESENTATIVES SO THAT WE COULD HELP HIM IN THE PROCESS. IN 1982, THE SBA PROPOSED A COMPLETE OVERHAUL OF THE INDUSTRY'S REGULATIONS, WHICH WERE ADOPTED AS REVISION 6 IN 1983. THE NEW RULES CAUSED DRASTIC CHANGES IN THE WAY WE STRUCTURED OUR DEALS. AFTER WE HAD A FEW YEARS TO GET USED TO THE NEW RULES, HOWEVER, CHARLES HEATHERLY STEPPED IN AS ACTING ADMINISTRATOR, AND TRIED TO COMPLETELY ELIMINATE OUR INDUSTRY. ALTHOUGH HE HAS BEEN REPLACED WITH AN ADMINISTRATOR WHO HAS VOWED TO PRESERVE THE SBA, WE RECENTLY LEARNED THAT WE WILL ONCE AGAIN BE FACING A MAJOR REVISION TO OUR REGULATIONS THIS YEAR.

IT IS NOT JUST THE REGULATIONS THEMSELVES THAT CONCERN US, HOWEVER. THE SBA HAS BEEN INCONSISTENT AND ARBITRARY IN ITS INTERPRETATION OF THE REGULATIONS AND OPERATING POLICIES. FOR APPARENTLY ARBITRARY REASONS, DIFFERENT OPERATING STANDARDS ARE PLACED ON COMPANIES. EACH MESBIC IS HELD TO A CERTAIN CAP ON ITS EXPENSE LEVEL, BUT THAT CAP MAY VARY FROM 4% TO 8% FOR NO APPARENT REASON. ONE OF NAIC'S PAST CHAIRMEN RECENTLY TESTIFIED BEFORE A HOUSE SMALL BUSINESS SUBCOMMITTEE THAT HE HAD LOST AN ACCOUNTANT AND WAS IN DANGER OF LOSING ADDITIONAL EXECUTIVE TALENT BECAUSE THE SBA HAD ARBITRARILY PLACED A LOW CAP ON HIS COMPANY'S EXPENSES. HE BELIEVED THE LOW CAP WAS DUE TO THE FACT THAT HIS COMPANY WAS NOT PAYING DIVIDENDS ON ITS PREFERRED STOCK

LEVERAGE. APPROPRIATELY, HE PUT THE QUESTION TO THE SUBCOMMITTEE, "IF OUR PRIVATE INVESTORS ARE WILLING TO ALLOW OUR RETAINED EARNINGS TO GO BACK INTO MINORITY BUSINESS INVESTMENTS, SHOULDN'T OUR GOVERNMENT PARTNERS BE WILLING TO DO THE SAME?

THIS SUBJECTIVITY ON THE PART OF SBA SPILLS OVER INTO OTHER AREAS AS WELL. OUR INDUSTRY'S FUNDING SHORTAGE HAS OPENED THE DOOR FOR SBA TO BECOME MUCH MORE SUBJECTIVE IN GRANTING LEVERAGE, AND THE INDUSTRY IS KEPT IN THE DARK REGARDING THE SBA'S FUNDING PRIORITIES. THEY ARE SUBJECTIVE AS WELL IN THEIR DETERMINATION OF APPROPIRATE ACTIVITIES, LICENSING A COMPANY TO SPECIALIZE IN A CERTAIN AREA ONE YEAR, THEN REFUSING TO GRANT LEVERAGE TO THE COMPANY A FEW YEARS LATER BECAUSE OF ITS SPECIALIZATION.

MESBICS ARE OFTEN HELD HOSTAGE BY THE SBA AS A RESULT OF REFERRALS TO THE INSPECTOR GENERAL. COMPANIES AND MATTERS REFERRED TO THE INSPECTOR GENERAL'S OFFICE MAY GO A YEAR OR MORE WITHOUT RESPONSE, DURING WHICH TIME THE COMPANIES ARE UNABLE TO PROCEED WITH ANY FUNDING REQUESTS. WE REALIZE THERE IS A LEGITIMATE MANPOWER SHORTAGE TO CONSIDER, BUT THE SIMPLE FACT REMAINS THAT WE HAVE TO MAINTAIN OUR DAY TO DAY OPERATIONS, AND THAT BECOMES VERY DIFFICULT IN SUCH AN UNSTABLE REGULATORY ENVIRONMENT. THIS INSTABILITY AND ARBITRARINESS ENCUMBERS THE ABILITY OF OUR INVESTORS TO MAKE THE TYPE OF LONG-TERM FINANCIAL DECISIONS THAT ARE REQUIRED OF VENTURE CAPITALISTS.

OUR SECOND OBJECTION TO SBA REGULATION OF THE INDUSTRY IS BASED ON MARKET PERCEPTION. ANY PERCEPTION BY WALL STREET THAT OUR OPERATIONS ARE GOVERNED BY PERSONS OTHER THAN INVESTMENT PROFESSIONALS MIGHT ADVERSELY AFFECT OUR COST OF MONEY WHEN THE CORPORATION ISSUES SECURITIES ON THE MARKET.

WE RECOGNIZE THE NEED FOR GOVERNMENT OVERSIGHT OF THE CORPORATION, BUT BELIEVE THAT THE HOUSE VERSION OF THE BILL OFFERS A PREFERRABLE ALTERNATIVE FOR ACHIEVING THIS GOAL. LIKE THE SENATE BILL, IT REQUIRES EXTENSIVE GOVERNMENT OVERSIGHT OF THE CORPORATION ITSELF, AND SEVERAL ANNUAL AUDITS AND REPORTS FROM DIFFERENT SOURCES. IT DIFFERS FROM THE SENATE BILL, HOWEVER, IN THAT THE ACTUAL RULEMAKING AUTHORITY, BEYOND THE RULES AND REGULATIONS CONTAINED IN THE LANGUAGE OF THE COSBI LEGISLATION, IS LEFT WITH THE PUBLIC AND PRIVATE SECTOR REPRESENTATIVES ON COSBI'S BOARD OF DIRECTORS.

CONCLUSION

I AM CONFIDENT THAT ONCE S. 1929 IS SIGNED INTO LAW, THE MESBIC INDUSTRY WILL SHOW A DRAMATIC INCREASE IN ITS GROWTH RATE. NOT ONLY WILL OUR EXISTING COMPANIES BE ABLE TO RECEIVE LEVERAGE ON A TIMELY BASIS, BUT THE LEVERAGE CERTAINTY AND STABILITY CREATED BY COSBI WILL ATTRACT AN INCREASED LEVEL OF PRIVATE INVESTMENTS TO THE INDUSTRY. AS THE COMMITTEE IS AWARE, WE HAVE PRODUCED COMPUTER MODELS OF THE MESBIC TRUST'S OPERATIONS DEMONSTRATING THAT THE TRUST WILL PROVIDE FOR INDUSTRY GROWTH FOR THE FULL 50 YEAR PERIOD PROVIDED FOR IN THE BILL.

IN SUMMARY, THE CORPORATION FOR SMALL BUSINESS INVESTMENT WILL PRODUCE IMPORTANT BENEFITS NOT ONLY TO THE SMALL BUSINESS INVESTMENT COMPANY INDUSTRY, BUT TO THE SMALL BUSINESSES IN WHICH WE INVEST. MESBICS WILL OPERATE IN A MORE STABLE REGULATORY ENVIRONMENT WITH GREATER ACCESS TO CAPITAL MARKETS THROUGH A FINANCIAL INTERMEDIARY DESIGNED TO MEET THE UNIQUE NEEDS OF SBICS. COSBI WILL PROVIDE ACCESS FOR SMALL BUSINESSES TO THE MAJOR CAPITAL MARKETS, INCREASING THE FLOW OF CAPITAL TO SMALL BUSINESSES BY MANY HUNDREDS OF MILLIONS OF DOLLARS PER YEAR.

I THANK YOU, MR. CHAIRMAN AND MEMBERS OF THE SMALL BUSINESS COMMITTEE FOR THIS OPPORTUNITY TO TESTIFY BEFORE YOU, AND WOULD BE HAPPY TO ANSWER ANY OF YOUR QUESTIONS.

MESBIC TRUST ANALYSIS

Intro

The data used to generate the attached model of the MESBIC trust were obtained from Jack Werner, Director of the Office of Investment of the Small Business Administration. These data include: 1) The schedule and report on Section 301(d) SBIC debentures as of December 31, 1986; 2) The balance outstanding on MESBIC preferred stock as of December 31, 1986; 3) The outstanding leverage to operating Section 301(d) SBICs as of December 31, 1986; 4) The Section 301(d) SBIC preferred stock dividends calendar; 5) The total outstanding Section 301(d) SBICs paying dividends as of December 31, 1986. It should be noted that the interest rates on the debenture schedule were understated by approximately 3%. Our model compensated for this discrepancy by taking a weighted average of the interest rates on the portfolio of approximately 12%.

Analysis of Existing SBA Debenture Portfolio

The amount of the existing debenture portfolio maturing each year is given in Column A of the attached table. The reserve for losses on non-operating companies given in Column C was derived by multiplying Column A by 18.58%. This figure represents the ratio of debentures held by non-operating companies to total outstanding debentures. We have thus assumed that approximately 18.58% of the debentures maturing each year will not be paid that year.

Column D represents the interest earned each year on the outstanding MESBIC debentures. As mentioned earlier in the introduction, we are working with a weighted average interest rate of 12%. Thus, in year 1, we would earn interest on the total outstanding portfolio of approximately $140,546,577 which would amount to $16,865,589. ($140,546,577 x .12 = $16,865,589). The 12% interest earned in later years would be applied to a declining balance as the debentures held reached maturity. Column E represents the portion of interest earned that is held by non-operating companies and is derived simply by multiplying the amount each year in Column D by .1858. In other words, Column E represents the amount of interest earned on debentures each year which is estimated uncollectible.

Column F, the remaining debenture subsidy, is taken directly from SBA records. Dividends paid currently, given in Column G, are a constant amount based on the 1986 level, with adjustments for preferred stock buy-backs. This amount was used as a reasonable estimate because there was no way to accurately reflect the true amount.

Net interest and dividends paid, given in Column H, represents interest earnings (Column D - Column E) less the remaining debenture subsidy (Column F) plus dividend payments (Column G). Finally, to determine the total annual cash flow generated for the trust, the maturing debentures, minus the loss reserve, (Column A - Column C) are added to the net interest and dividends paid (Column H). Thus, the total annual cash flow generated by the existing MESBIC portfolio that would be available to the trust is given in Column I.

MESBIC Trust Analysis

The trust has three sources of funds for investment; 1) The initial amount transferred by Congress; 2) Cash generated by the MESBIC portfolio including buybacks on the existing preferred and calls on the newly issued preferred; and 3) Interest earned on available funds assuming a constant interest rate of 6.5%. Disbursements from the fund take the form of preferred stock purchases, 3% subsidies on MESBIC debentures, fees paid for administration of the trust, and funded loss reserves, which are an estimated 11% of debentures issued and which are not drawn down in this analysis. In addition, the debentures subsidy assumes an average six month subsidy for new debentures issued each year.

Model

The model examines the operations of the trust over a 50 year period given the following assumptions:

1) The trust receives $150 million in from the sale of the FFB portfolio durings its first year of operation.

2) MESBICs are given the option of buying back their existing preferred at 40 cents on the dollar. 50% of outstanding preferred is assumed to be bought back in year 1, 10% in year 2, and 10% in year 3. The income from these sales is reflected under initial balance for these years.

3) Newly issued preferred stock is 3% cummulative, with a 10 year call provision. Preferred stock purchases by the trust are assumed to increase 1% per year, with 78% of the calls recoverable. As the stock is called, it is assumed that the stock is rolled over into a debenture with a 3% subsidy paid by the trust for the first five years.

4) Debentures are assumed to carry a 3% subsidy on the interest rate for the first five years. The amount of debentures issued increases 7.4% per year.

5) For the purpose of simplification and conservatism, the deeper-discount, longer term debenture alternative is not shown in this model. Since this is an alternative to preferred stock

leverage, which would be more expensive to the trust (the trust covers 100% of the preferred stock leverage while it covers only the subsidy on debentures), this model demonstrates that even under the most conservative circumstances, the trust can provide growth for the MESBIC industry over a 50 year period.

Given the above assumptions, the model shows that the trust would continue to operate profitably for the 50 year period demonstrated.

MAIC Analysis of Existing SBA Debenture Portfolio

DEBENTURE MATURITY DATE	AMOUNT MATURING EACH YEAR	% REPAID EACH YEAR	RESERVE FOR LOSSES NON-OPERATING	INTEREST EARNED	LESS INTEREST FROM NON-OPERATING	REMAINING DEBENTURE SUBSIDY	DIVIDENDS PAID CURRENTLY	NET INTEREST AND DIVIDENDS PAID	INCOME AND REPAID DEBENTURES
				12.00%	18.58%	3.00%			
12/30/84	0	0.00%	0	0	0	0	0	0	0
12/30/85	0	0.00%	0	0	0	0	0	0	0
12/30/86	0	0.00%	0	0	0	0	0	0	0
12/30/87	0	0.00%	0	0	0	0	0	0	0
12/30/88	0	0.00%	0	0	0	0	0	0	0
12/30/89	5952893	3.79%	1106048	16865589	3133626	2776029	1073743	12029677	16876522
12/30/90	5119526	3.26%	951208	16151242	3000901	2210398	858994	11798938	15967256
12/30/91	10671619	6.79%	1982787	15536899	2886756	1713405	644246	11580984	20269816
12/30/92	9850353	6.27%	1830196	14256305	2648821	1170000	644246	11081729	19101886
12/30/93	16417890	10.45%	3050444	13074262	2429198	585000	644246	10704310	24071756
12/30/94	18854378	12.00%	3503143	11104116	2063145		644246	9685216	25036451
12/30/95	16566423	10.55%	3078041	8841590	1642767		644246	7843068	21331450
12/30/96	18113495	11.53%	3365487	6853619	1273402		644246	6224463	20972470
12/30/97	19500000	12.41%	3623100	4680000	869544		644246	4454702	20331602
12/30/98	19500000	12.41%	3623100	2340000	434772		644246	2549474	18426374
"12/31/01	0	0.00%	0	0	0		644246	644246	644246
"12/31/02	0	0.00%	0	0	0		644246	644246	644246
TOTALS	140546577	100.00%	26113554	109703622	20382933	8454831	8375193	89241051	203674074

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
FUNDS BEGINNING										
INITIAL BALANCE	0	150000000	197335283	210942497	229085598	237574705	250842268	265619877	277162292	288690508
CASH FROM DEBN. PORTFOLIO	0	16876522	15967256	20269816	19101886	24071756	25036451	21331450	20972470	20331602
INTEREST ON CASH BALANCES	0	9550987	12708404	13851470	15120806	15972029	17033839	18054931	18988335	19926537
CASH FROM PREF. PORTFOLIO	0	43907774	8941555	9103155	484816	649664	816161	984322	1154166	1325707
INTEREST ON 6.50%										
	0	220335283	234952497	254166938	263793106	278268154	293728720	305990581	318277263	330274354
DISBURSEMENTS:										
NEW PREFERRED STOCK PURCHAS	0	20000000	20200000	20402000	20606020	20812080	21020201	21230403	21442707	21657134
DEBENTURES SUBSIDY	0	300000	922200	1590443	2308136	3078938	3306779	3551481	3814290	4096548
ADMINISTRATIVE FEE	0	500000	525000	551250	578813	607753	638141	670048	703550	738728
FUNDED LOSS RESERVES	0	2200000	2362800	2537647	2725433	2927115	3143722	3376357	3626207	3894547
PREF. INC. 101.00%										
DEBENTURE LO 11.00%	0	23000000	24010000	25081340	26218401	27425886	28108842	28828289	29586755	30386956
CASH BALANCE	0	197335283	210942497	229085598	237574705	250842268	265619877	277162292	288690508	299887397
COSBI DEBENTURES ISSUED	0	20000000	21480000	23069520	24776664	26610138	28579288	30694155	32965523	35404971
CUMULATIVE DEBENTURES	0	20000000	41480000	64549520	89326184	115936322	144515610	175209765	208175288	243580259
DEB. RATE OF IN 107.40%										

DIVIDEND RATE NEW PREFERRED 5.00%
DIVIDEND RATE OLD PREFERRED 3.00%
RECOVERABLE PREFERRED 78.00%

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
PREFERRED OUTSTANDING BEGINNI	0	219538868	129769434	149769434	148015547	168621567	189433647	210453848	231684251	253126958
NEW PREFERRED ISSUED	0	20000000	20200000	20402000	20606020	20812080	21020201	21230403	21442707	21657134
CUM. NEW PREFERRED ISSUED	0	20000000	40200000	60602000	81208020	102020100	123040301	144270704	165713411	187370545
DISCOUNTED PREFERRED	0	43907774	8781555	8781555	0	0	0	0	0	0
REDEEMED PREFERRED		0	0	0	0	0	0	0	0	0
DIVIDEND PAID ON NEW PREFERRE	0	0	160000	321600	484816	649664	816161	984322	1154166	1325707
CASH FROM PREFERRED HOLDERS	0	43907774	8941555	9103155	484816	649664	816161	984322	1154166	1325707
PRREFERRED OUTSTANDING END	0	129769434	149769434	148015547	168621567	189433647	210453848	231684251	253126958	274784093

ASSUMPTIONS:
APPROPRITION:

1989	150000000
1990	0
1991	0

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
FUNDS BEGINNING											
INITIAL BALANCE	299887397	309455807	318645180	328117800	338526056	349232023	359553791	370092789	380821450	391707298	402712401
AVAILABLE TRUST FUNDS	18426374	0	0	644246	644246	0	0	0	0	0	0
INTEREST ON APPROPRIATI	20818103	21084061	21942696	22860509	23839503	24839797	25860641	26922017	28024093	29166466	30350132
CASH FROM PREF. PORTFOL	1555738	20229738	20598095	20970136	21345897	21725416	22108730	22495878	22886897	23281826	23680704
INTEREST ON DEPOSITS											
	340687612	350769605	361185970	372592691	384355702	395797236	407523163	419510684	431732440	444155989	456743237
DISBURSEMENTS:											
PREFERRED STOCK	21873705	22092443	22313367	22536501	22761866	22989484	23219379	23451573	23686089	23922950	24162179
DEBENTURES SUBSIDY	4399692	4725269	5074939	5450485	5853821	6287003	6752242	7251908	7788549	8364901	8983904
ADMINISTRATIVE FEE	775664	814447	855170	897928	942825	989966	1039464	1091437	1146009	1203310	1263475
FUNDED LOSS RESERVES	4182743	4492266	4824694	5181721	5565169	5976991	6419289	6894316	7404495	7952428	8540908
PREF. REDUCTION %											
DEBENTURE LOSS %	31231805	32124426	33068170	34066635	35123680	36243445	37430374	38689234	40025142	41443589	42950466
REMAINING BALANCE	309455807	318645180	328117800	338526056	349232023	359553791	370092789	380821450	391707298	402712401	413792771
COSBI DEBENTURES ISSUED	38024939	40838785	43860855	47106558	50592443	54336284	58357169	62675600	67313594	72294800	77644615
CUMULATIVE DEBENTURES	281605198	322443983	366304838	413411396	464003839	518340123	576697292	639372892	706686486	778981286	856625901
DEB. RATE OF INCREA											
DEBENTURE RESERVE											

RECOVERABLE PREFERRED

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
PREFERRED OUTSTANDING BEG	274784093	296657798	298750241	300863607	302998108	305153954	307331358	309530536	311751706	313995087	316260903
NEW PREFERRED ISSUED	21873705	22092443	22313367	22536501	22761866	22989484	23219379	23451573	23686089	23922950	24162179
CUM. NEW PREFERRED ISSUE	209244251	215736693	222294060	228917001	235606171	242362233	249185855	256077713	263038491	270068875	277169564
DISCOUNTED PREFERRED	0	0	0	0	0	0	0	0	0	0	0
REDEEMED PREFERRED	0	15600000	15756000	15913560	16072696	16233423	16395757	16559714	16725311	16892565	17061490
DIVIDEND PAID ON NEW PREF	1555738	4629738	4842095	5056576	5273202	5491994	5712974	5936163	6161585	6389261	6619214
CASH FROM PREFERRED HOLDE	1555738	20229738	20598095	20970136	21345897	21725416	22108730	22495878	22886897	23281826	23680704
PRREFERRED OUTSTANDING E	296657798	298750241	300863607	302998108	305153954	307331358	309530536	311751706	313995087	316260903	318549376

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
413792771	424915271	436005520	446997253	457815133	468373810	478576896	488315844	497468729	505898908
0	0	0	0	0	0	0	0	0	0
31573462	32837312	34139651	35479183	36854243	38262759	39702196	41169504	42661064	44172614
24101135	24508207	24919349	25334602	25754008	26177608	26605444	27037559	27473995	27914794
469467368	482260790	495064520	507811038	520423385	532814178	544884536	556522908	567603787	577986317
24403801	24647839	24894317	25143260	25394693	25648640	25905126	26164178	26425819	26690078
9648713	10362718	11129559	11953146	12837679	13787667	14807955	15903743	17080620	18344586
1326649	1392981	1462630	1535762	1612550	1693177	1777836	1866728	1960065	2058068
9172935	9851732	10580760	11363736	12204653	13107797	14077774	15119530	16238375	17440014
44552097	46255270	48067267	49995905	52049575	54237282	56568692	59054179	61704879	64532746
424915271	436005520	446997253	457815133	468373810	478576896	488315844	497468729	505898908	513453571
83390317	89561200	96188729	103306695	110951390	119161793	127979766	137450268	147621588	158545586
940016217	1029577417	1125766146	1229072841	1340024231	1459186024	1587165790	1724616059	1872237647	2030783233

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
318549376	320860735	323195206	325553023	327934418	330339626	332768887	335222441	337700530	340203399
24403801	24647839	24894317	25143260	25394693	25648640	25905126	26164178	26425819	26690078
284341260	291584672	298900519	306289524	313752420	321289944	328902843	336591872	344357790	352201368
0	0	0	0	0	0	0	0	0	0
17232105	17404426	17578470	17754255	17931798	18111116	18292227	18475149	18659901	18846500
6869030	7103781	7340878	7580347	7822211	8066493	8313218	8562410	8814094	9068295
24101135	24508207	24919349	25334602	25754008	26177608	26605444	27037559	27473995	27914794
320860735	323195206	325553023	327934418	330339626	332768887	335222441	337700530	340203399	342731298

2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
513453571	519962150	525234596	529059492	531202005	531401652	529369872	524787380	517301293	506522002
0	0	0	0	0	0	0	0	0	0
45699187	47235029	48773514	50307049	51826979	53323467	54785378	56200143	57553618	58829919
28360002	28809662	29263819	29722517	30185802	30653720	31126318	31603641	32085737	32572655
587512761	596006842	603271928	609089058	613214786	615378839	615281567	612591164	606940648	597924575
26956978	27226548	27498814	27773802	28051540	28332055	28615376	28901529	29190545	29482450
19702086	21160040	22725883	24407598	26213761	28153579	30236944	32474477	34877589	37458530
2160971	2269020	2382471	2501594	2626674	2758008	2895908	3040703	3192739	3352376
18730576	20116638	21605269	23204059	24921160	26765325	28745960	30873161	33157774	35611450
67550611	70772246	74212437	77887054	81813134	86008967	90494187	95289871	100418647	105904806
519962150	525234596	529059492	531202005	531401652	529369872	524787380	517301293	506522002	492019769
170277959	182878528	196411539	210945993	226555997	243321140	261326905	280665096	301434313	323740452
2201061192	2383939720	2580351260	2791297253	3017853250	3261174390	3522501295	3803166391	4104600704	4428341156

2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
342731298	345284475	347863185	350467681	353098222	355755069	358438484	361148734	363886086	366650811
26956978	27226548	27498814	27773802	28051540	28332055	28615376	28901529	29190545	29482450
360123382	368124616	376205862	384367921	392611600	400937716	409347093	417840564	426418970	435083159
0	0	0	0	0	0	0	0	0	0
19034965	19225314	19417567	19611743	19807861	20005939	20205999	20408058	20612139	20818260
9325038	9584348	9846252	10110774	10377942	10647781	10920319	11195582	11473598	11754394
28360002	28809662	29263819	29722517	30185802	30653720	31126318	31603641	32085737	32572655
345284475	347863185	350467681	353098222	355755069	358438484	361148734	363886086	366650811	369443184

2029	2030	2031	2032	2033	2034	2035	2036	2037	2038
492019769	473321038	449904412	421196293	386566144	345321340	296701587	239872850	173920777	97843559
0	0	0	0	0	0	0	0	0	0
60011255	61077738	62007175	62774846	63353263	63711898	63816899	63630773	63112045	62214884
33064441	33561146	34062817	34569505	35081260	35598133	36120174	36647436	37179970	37717830
585095466	567959922	545974404	518540644	485000667	444631371	396638660	340151059	274212793	197776273
29777275	30075047	30375798	30679556	30986351	31296215	31609177	31925269	32244522	32566967
40230462	43207516	46404872	49838833	53526906	57487897	61742002	66310910	71217917	76488043
3519994	3695994	3880794	4074833	4278575	4492504	4717129	4952986	5200635	5460667
38246697	41076953	44116647	47381279	50887494	54653168	58697503	63041118	67706160	72716416
111774428	118055510	124778111	131974501	139679326	147929784	156765810	166230282	176369234	187232093
473321038	449904412	421196293	386566144	345321340	296701587	239872850	173920777	97843559	10544181
347697246	373426842	401060428	430738900	462613578	496846983	533613660	573101071	615510550	661058331
4776038401	5149465243	5550525671	5981264571	6443878149	6940725132	7474338792	8047439862	8662950412	9324008743

2029	2030	2031	2032	2033	2034	2035	2036	2037	2038
369443184	372263480	375111979	377988964	380894718	383829530	386793689	389787491	392811230	395865207
29777275	30075047	30375798	30679556	30986351	31296215	31609177	31925269	32244522	32566967
443833991	452672331	461599054	470615045	479721195	488918407	498207591	507589667	517065564	526636219
0	0	0	0	0	0	0	0	0	0
21026443	21236708	21449075	21663565	21880201	22099003	22319993	22543193	22768625	22996311
12037998	12324438	12613742	12905940	13201059	13499130	13800181	14104243	14411345	14721519
33064441	33561146	34062817	34569505	35081260	35598133	36120174	36647436	37179970	37717830
372263480	375111979	377988964	380894718	383829530	386793689	389787491	392811230	395865207	398949724

MESBIC TRUST
PROFORMA BALANCE SHEET

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
ASSETS:											
CASH	0	197335283	210942497	229085598	237574705	250842268	265619877	277162292	288690508	299887397	309455807
DEBENTURES REC.	0	140546577	134593684	129474158	118802539	108952186	92534296	73679918	57113495	39000000	19500000
PREFERRED REC.	0	129769434	149769434	148015547	168621567	189433647	210453848	231684251	253126958	274784093	296657798
FUNDED LOSS RES.	0	2200000	4562800	7100447	9825880	12752995	15896717	19273074	22899282	26793828	30976572
PREF. DIV. REC	0	31364111	26493302	24945676	25923360	27582145	29257517	30949644	32658691	34384829	36128228
TOTAL	0	501195405	526361717	538621426	560748052	589563242	613762256	632749179	654488934	674850148	692718405
LIABILITIES:											
DEBEN. SUB. PAYAB	0	5476029	4510198	3583390	2578364	1497583	980114	1052643	1130538	1214198	1304049
TRUST BALANCE	0	495719376	521851520	535038036	558169688	588065659	612782142	631696537	653358396	673635950	691414356
TOTAL LIA. &BAL	0	501195405	526361717	538621426	560748052	589563242	613762256	632749179	654488934	674850148	692718405

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
ASSETS:											
CASH	318645180	328117800	338526056	349232023	359553791	370092789	380821450	391707298	402712401	413792771	424915271
DEBENTURES REC.	0	0	0	0							
PREFERRED REC.	298750241	300863607	302998108	305153954	307331358	309530536	311751706	313995087	316260903	318549376	320860735
FUNDED LOSS RES.	35468838	40293532	45475254	51040422	57017414	63436702	70331018	77735513	85687941	94228849	103401784
PREF. DIV. REC	37109062	37499703	37894251	38292745	38695223	39101726	39512295	39926969	40345789	40768798	41196037

TOTAL	689973320	706774643	724893669	743719143	762597785	782161754	802416468	823364867	845007034	867339795	890373827
LIABILITIES:											
DEBEN. SUB. PAYABLE	1400548	1504189	1615499	1735046	1863439	2001334	2149432	2308490	2479319	2662788	2859834
TRUST BALANCE	688572772	705270454	723278170	741984098	760734346	780160420	800267036	821056377	842527716	864677006	887513992

TOTAL LIA. &BAL.	689973320	706774643	724893669	743719143	762597785	782161754	802416468	823364867	845007034	867339795	890373827

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         2010         2011         2012         2013         2014         2015         2016         2017         2018         2019

    436005520    446997253    457815133    468373810    478576896    488315844    497468729    505898908    513453571    519962150

    323195206    325553023    327934418    330339626    332768887    335222441    337700530    340203399    342731298    345284475
    113253516    123834276    135198013    147402665    160510463    174588237    189707766    205946141    223386156    242116731
     41627549     42063375     42503560     42948147     43397179     43850702     44308760     44771398     45238663     45710601
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    914081791    938447928    963451124    989064248   1015253425   1041977224   1069185785   1096819847   1124809688   1153073958
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      3071462      3298750      3542858      3805029      4086602      4389010      4713797      5062618      5437252      5839608
    911010329    935149177    959908266    985259219   1011166823   1037588214   1064471988   1091757230   1119372436   1147234349
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    914081791    938447928    963451124    989064248   1015253425   1041977224   1069185785   1096819847   1124809688   1153073958
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         2020         2021         2022         2023         2024         2025         2026         2027         2028         2029

    525234596    529059492    531202005    531401652    529369872    524787380    517301293    506522002    492019769    473321038

    347863185    350467681    353098222    355755069    358438484    361148734    363886086    366650811    369443184    372263480
    262233369    283838639    307042698    331963857    358729183    387475142    418348303    451506077    487117527    525364224
     46187258     46668682     47154919     47646020     48142031     48643002     49148983     49660024     50176175     50697488
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   1181518408   1210034493   1238497845   1266766598   1294679570   1322054259   1348684665   1374338914   1398756656   1421646231
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      6271739      6735848      7234301      7769639      8344592      8962092      9625287     10337558     11102537     11924125
   1175246669   1203298645   1231263544   1258996959   1286334978   1313092167   1339059378   1364001356   1387654118   1409722105
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   1181518408   1210034493   1238497845   1266766598   1294679570   1322054259   1348684665   1374338914   1398756656   1421646231
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         2030         2031         2032         2033         2034         2035         2036         2037         2038         2039

    449904412    421196293    386566144    345321340    296701587    239872850    173920777     97843559     10544181    -89177980

    375111979    377988964    380894718    383829530    386793689    389787491    392811230    395865207    398949724    402065085
    566441177    610557824    657939103    708826596    763479765    822177267    885218385    952924545   1025640962   1103738393
     51224014     51755805     52292914     52835394     53383299     53936683     54495601     55060108     55630260     56206114
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   1442681582   1461498886   1477692878   1490812861   1500358340   1505774291   1506445994   1501693420   1490765126   1472831612
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     12806510     13754192     14772002     15865131     17039150     18300047     19654251     21108665     22670707     24348339
   1429875072   1447744693   1462920876   1474947730   1483319190   1487474244   1486791743   1480584754   1468094419   1448483273
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   1442681582   1461498886   1477692878   1490812861   1500358340   1505774291   1506445994   1501693420   1490765126   1472831612
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ANSWERS TO QUESTIONS FROM SENATORS BUMPERS AND WEICKER FEBRUARY 24, 1988 HEARING RECORD

1. How can the Committee be assured that the MESBIC industry, including those companies that are not members of your trade association fully support the COSBI proposal? Is the industry divided on this question?

Were your members surveyed to determine their support or lack of support for COSBI? If not, do you intend to make such a survey?

The MESBIC industry is 100% behind the COSBI proposal. Our industry made a conscious decision to move forward in tandem with the SBICs to find a long term solution to our funding and policy problems. Be assured that if the SBIC industry is committed to COSBI becuase of the stability it offers, the MESBIC industry is even more committed, because COSBI represents our chance for survival.

Although we can not speak officially for MESBICs who are not members of NAIC, we have had non-members attend our regional sessions on COSBI, and our annual conventions where COSBI was discussed extensively, and they have always voiced support for the proposal. NAIC has not conducted a membership survey on the question, and currently has no plans to do so, because we are confident of our ability to guage the level of support for COSBI through our meetings and conversations with licensees.

In addition, we are aware that in the past the House Small Business Committee has issued invitations to all Association non-members to present testimony during hearings if they oppose COSBI, and no MESBIC ever came forward to take advantage of the opportunity.

2. Do you believe that the MESBIC industry will continue to receive as favorable treatment under COSBI as it does under the present MESBIC program at SBA?

As outlined in detail in our February 24 statement before the Committee, we do not believe we are currently receiving favorable treatment at the SBA. The SBA has made very clear its intentions to eliminate the MESBIC industry.

On the other hand, COSBI would finally provide the industry with financing and regulatory stability. Our computer models show that the trust can provide the industry with an adequate growth level for fifty years. The makeup of the trustees ensures fair treatment in providing preferred stock leverage and debenture subsidies, while the trust's coverage of losses on MESBIC debentures makes MESBIC fundings at the COSBI window even more attractive than those of regular SBICs.

3. How does the MESBIC industry expect to be represented on the COSBI board of directors--i.e., how many directors do you believe you can elect as stockholders, in addition to the one provided for in the bill?

Are you satisfied with the MESBIC representation that this legislation would provide?

The MESBIC industry anticipates that we will be able to elect one, and possibly two, representatives to the COSBI board of directors in addition to the one provided for in the bill.

We believe that board representation based on stock ownership is reasonable, and therefore are satisfied with the bill's provisions in that regard. This is particularly true since the most important operations of the Corporation from the MESBIC perspective--the MESBIC trust--will be managed by a separate board of trustees, a majority of which will be nominated by the MESBIC industry.

4. As you know, the Administration's FY 89 budget proposed the elimination of all direct funding for the MESBIC program and that MESBICs obtain leverage through the private capital markets like SBICs. Would you please explain the effect this proposal will have on the MESBIC industry.

How do you respond to the argument that under COSBI, MESBIC funding will come from the same source as regular SBICs and therefore the Administration budget proposal is moving in that same direction of "mainstreaming" the program?

On its face, the Administration's proposal looks like a move toward privatization. The SBA would simply take what is now a direct loan program and make it a guaranteed loan program. In the process, however, they will also remove the incentives to be in the program. The Administration proposes that MESBICs receive leverage from the SBIC Funding Corporation under the same terms and conditions as regular SBICs. As MESBICs, however, they would continue to be limited in their investments to those companies that are socially or economically disadvantaged. In other words, they would pay the same rates for funds as regular SBICs, but limit their use of those funds to the riskiest 6% of the SBIC's potential use of the same funds. This proposal would drive companies out of the industry.

The Administration has claimed before this Committee that the MESBIC industry can survive without special incentives. The assumption inherent in the SBA's claims is that private investors will continue to invest in the MESBIC industry even when the special incentives are removed. One need only look at what has happened to private investments in MESBICs during the recent shortage of these incentives to understand the fallacy of that argument.

In 1980, when our funding was stable and investors were confident of the availability of our special incentives, we had a private capital growth rate of 27%. By last year, however, our funding uncertainty had caused that growth to fall from 27% to less than 1%. And for every company that entered the industry lasat year, three left. If this is the private sector's response to the uncertainty of our special incentives, I leave it to you to predict its response to the complete elimination of those incentives.

It is not entirely true to say that under COSBI, MESBIC funding will come from the same source as regular SBICs. In the first place, MESBIC preferred stock leverage will come from the MESBIC trust, not COSBI. In the second place, although MESBICs will obtain their debentures from the COSBI financing window along with regular SBICs, they will have to obtain the important debenture subsidy from the MESBIC trust, which will also fully guarantee the Corporation against any losses on MESBIC debentures. Obviously, the big difference between the Administration's FY 89 budget proposal and COSBI is that COSBI continues the special incentives for MESBICs while the Administration's budget proposal completely eliminates those incentives.

ANSWERS TO SENATOR DIXON'S QUESTIONS
FEBRUARY 24, 1988 HEARING RECORD

1. Please give a history of the number of MESBICs which entered and left the industry by year, beginning at 1980. Of the MESBICs which left how many have defaulted on their debentures?

Year	Entered	Left	Total	Change	%Change
1980	31	12	129	19	17.27%
1981	16	18	127	- 2	-1.55%
1982	11	3	135	8	6.30%
1983	21	12	144	9	6.67%
1984	9	7	146	2	1.39%
1985	13	14	145	-1	-0.68%
1986	8	16	137	-8	-5.52%
1987	6	18	128	-9	-6.57%

Information on debenture defaults is available only from the SBA Investment Division.

2. In your testimony you suggest that MESBICs have a very limited scope of investment opportunities and therefore deserve special incentives. Yet you also state that you have had more investment opportunities than funds. Would you please reconcile the two statements and explain why it is necessary for MESBICs to continue to have a subsidy?

Is there a requirement that the benefit of the current MESBIC subsidy must be passed on to the minority small businesses financed by a MESBIC? If so, what is the mechanism by which it is done?

MESBICs have a very limited scope of investment opportunities compared to other venture capitalists because they are restricted to investing in small businesses owned by socially or economically disadvantaged entrepreneurs. According to President Reagan's The State of Small Business 1987, minority businesses comprise only 6% of small businesses in the country. In addition to being restricted to investing in a small percentage of the businesses in which other venture capitalists may invest, MESBICs provide funding to entrepreneurs who have historically been denied the same educational and management training opportunities other entrepreneurs may have. This makes our small pool of eligible investments even higher risk relative to other investment opportunities.

Typically, in order for investors to accept a higher level of risk in their investments, they expect a higher rate of return. On this basis, minority entrepreurs, who through past racial inequities were denied education and management training opportunities that might lower their perceived risk level as entrepreneurs, would be expected to pay higher rates of return to their investors.

This was, in fact, the case in the early seventies, when the Administration realized that there was no organized, reasonably-priced source of venture capital for the minority small business community. At that time, the Administration made the public policy decision that minority-owned businesses should have access to venture capital on terms similar to those available to the general small business community. It also realized, however, that in order to induce private sector investors to accept the higher level of risk inherent in restricting investments to minority-owned businesses without charging higher rates of return, the government must offer special incentives to the investors. Thus, the intended recipient of the MESBIC subsidy is, and always has been, the investor.

Although MESBICs have a limited scope of investment opportunities, we are even more limited in the leverage funds we currently receive from the government. The MESBIC industry has developed the minority business community over the years to the point where investment opportunities are more numerous. Just as important, the industry has developed a corps of professional investment executives who specialize in the minority venture capital business. Our executives are often approached by representatives from other countries who want to learn from us how to deal with their own minority business concerns. Unfortunately, at the same time we have developed expertise in identifying minority venture capital opportunities, our funds for taking advantage of those opportunities have been decreasing. First, our government leverage began to decrease, and now our private sector investors have responded by diminishing their investments in the industry. For the first time in 1987, total private sector investments actually decreased from the year before.

It is only natural that, as funding to the industry declines, the number of investments made by the industry decline. This was, in fact, the case, as our investments fell from $145 million in 1986 to $143 million in 1987. Although this was only a small decrease, we expect the downward trend to continue as MESBICs use up their capital reserves and future leverage funding continues to dwindle. In order to stop this exodus from the minority venture capital arena, the government must provide stability for the MESBIC subsidy.

3. Your testimony proposes that the MESBIC trust fund longer (15 yr.) and deeper (4%) debenture subsidies. Why is it necessary for the MESBIC industry to be granted a greater subsidy than it currently enjoys?

The MESBIC trust would not provide greater subsidies than the industry currently has. MESBICs currently are provided leverage funds in two different forms. First, the government purchases ten-year debentures from MESBICs at the Treasury rate, minus a three percent interest subsidy for the first five years. During the second five years, the interest rate reverts back to the original Treasury rate. MESBICs also receive leverage funds through the government's purchase of 3% cummulative preferred stock in MESBICs. There is no put on this preferred stock, and therefore it qualifies as pure equity in the company.

Under the COSBI trust proposal, MESBIC preferred stock would have a put provision. Under the new tax laws, stock with put provisions qualify as debt, rather than equity, as was previously the case. The new preferred issued by the Trust would have a significant impact on the balance sheets of MESBICs, since the leverage which they previously were able to receive as equity would now be identified as debt, affecting their debt/equity ratios. Due to this concern, the industry worked with Congressional staff to develop a low cost alternative to the preferred stock that would still serve the purpose of the old preferred stock (low-cost, "patient" funds) that had no put provision.

The alternative is the longer term, deeper discount debenture. It is important to distinguish, however, that this special debenture is available only as an alternative to the preferred stock leverage, and each company must still pass the more stringent requirements (a higher level of equity-type investments) to obtain this form of leverage.

4. Why is it necessary for a 10-year call option to be added to the MESBIC preferred stock instruments?

This provision was added at the request of Congressional staff to insure a payback to the government on its investment. Although the industry has agreed to the addition of the option, we would prefer a longer term on the option (e.g., 12-15 years), to allow MESBICs sufficent time to generate the necessary cash flow for payback from their own investments.

5. Your testimony suggests that the types of investments which the MESBICs make are somewhat riskier than those of the SBIC industry as a whole. If that is true, why is a MESBIC permitted to concentrate a greater percentage of investment of its capital in a single company than SBICs? Doesn't that expose a MESBIC to a greater risk?

According to the explanation given by SBA Administrator Thomas W. Kleppe in the July 2, 1971 Federal Register, when the rule was originally proposed, "Experience has shown that the 20 percent limitation imposes a hardship on MESBICs, and particularly the smaller ones, since it requires them to make smaller and therefore more numerous investments than their limited resources permit them to supervise effectively." The SBA therefore allowed MESBICs to invest up to 30% of their private capital in a single concern. This differential was continued in Revision 6 of the regulations.

6. The MESBIC Trust Analysis attached to your testimony states that the debenture interest rates given by the SBA were understated by 3%. Would you please explain your basis for making that claim and provide underlying data to support your contention?

It is our understanding that this mistake was made in-house at the SBA as MESBIC data was transferred from one division to another. The mistake has since been corrected, as can be confirmed by SBA Investment Division Director Jack Werner.

7. Is there a limit as to how much the MESBIC industry in aggregate can invest in any one business? You quoted in your oral testimony that six MESBICs had invested in a silicon chip manufacturer. Is there any coordination between MESBICs to ensure that the industry is not unduly exposed to financial risk due to a high concentration of MESBIC financing?

There is no specific limitation on how much the MESBIC industry in aggregate can invest in any one business, although the percentage limitation discussed in question 5 above, combined with the fact that we may invest only in small businesses, provides a ceiling on our exposure.

Senator **Weicker**. Thank you very much.

I would ask unanimous consent that a statement of mine be entered into the record prior to the testimony of these two witnesses and subsequent to the testimony of the Chairman.

Senator Kerry.

Senator **Kerry**. Mr. Chairman, thank you. What do I call you Mr. Vice Chairman? Mr. Minority Chairman? I thought we were chairmen.

Senator Weicker. Believe me. There is nothing that you are going to call me that I haven't heard before. [Laughter.]

Senator **Kerry**. The only thing is if I do it nowadays, I might get arrested or you. [Laughter.]

I would like to ask unanimous consent also—I have a statement—that it appear in the record at whatever the appropriate place is.

Mr. Chairman, I cosponsored this last year, and I have held off from being cosponsor this year though I am going to be a cosponsor and want my name added. The reason I have held off is that I think that there is an amendment that I'm interested in with respect to some high technology focus that I would like to see within the COSBI effort. But I think this is an important effort, and I hope the Administration may finally turn around and join us in it rather than oppose it.

Senator **Weicker**. Thank you very much.

Senator Kasten.

Senator **Kasten**. Mr. Chairman, thank you. I also would ask unanimous consent to insert my entire statement into the record at the appropriate place.

I am a cosponsor of this legislation. I am pleased to be here today to endorse the COSBI Charter Act. Since it created the Small Business Investment Companies in 1958, Congress has considered the availability of long-term equity and debt financing to be one of the most important areas where the political process can help the small business community. And COSBI would oversee the whole SBIC process, raising capital, and I believe enhancing small business access to capital markets. That is why I am a cosponsor, I am hopeful that we can move, at least in this committee, quickly on this legislation.

I think in creating COSBI we in Congress are saying yes to seed money, to the essential first steps any business has to take in order to eventually make a substantial contribution to the life of the community. So, I think that what we have got here is an innovative, farsighted approach to one of our Nation's top priorities, or what should be one of our Nation's top priorities. I am hopeful that we are going to move quickly with this legislation in the Senate with strong bipartisan support. This is one of those issues that unites, not divides, Republicans and Democrats. This is an issue that we have a responsibility, I believe, to work together on, and I am anxious to be part of that team.

Mr. Chairman, thank you.

Senator **Weicker**. Thank you very much, Senator Kasten.

Just a few questions. I'll submit questions for the response to the record because I understand a roll call vote is imminent on the Floor. But let me ask a few before that rings.

The Administration would argue that the SBIC industry has not utilized the full appropriated program level for the last 2 years. How would you respond to their claim that there is no need for this legislation because the industry has not used the full amount of the funds appropriated?

Mr. JONES. If I may, Senator, I would like to respond to that briefly. I think there are two major factors in the gap between the amount of the appropriation and the amount of leverage taken down by SBICs over the last 2 years.

First and foremost has been what the industry considers to be an arbitrary and capricious set of standards by the agency in approving applications for leverage. I think you will find that there have been applications for leverage approaching or exceeding the amount of the appropriation. The agency has not approved all of the applications. In the last financing, for example, there were I think over $56 million in applications and only $20 million in approvals granted. And frankly, half of our industry is standing around scratching their heads saying why were our applications denied. They can't figure out any reasons for them. So, there is a gatekeeper in the process, which is the agency, and we can't understand what rules it applies to open the gate.

Second, I would say as a result of that, a number of SBICs have simply refused to go to the well and to plan their investment programs based on a program that they don't know whether they're even going to be in this program 3 years from now or 4 years from now. And they are reluctant to go in and take down 10-year financing commitments and borrow money for 10 years when I think there is just so much uncertainty in the industry that people are not prepared to take on those obligations.

And third, frankly, in the period 1983 through 1985, the public stock markets were ebullient, and there was some increased liquidity in the industry which enabled people to cash out their prior investments instead of having to go to the windows.

Mr. KAMATH. Senator Weicker, I would like to add to that. From the MESBIC perspective, the backlog has always exceeded the available funds. And I think if this uncertainty were removed, you would probably see even more people applying for funds. So, that statement doesn't apply for the MESBIC's especially.

Senator WEICKER. The bell has just rung for a vote on the Floor. And I will recess this hearing pending the arrival of Senator Bumpers. He will be doing his vote, as I understand, then coming directly from the floor to resume the hearings.

I do have further questions for this panel, but I think in the interest of time and the kind of back-and-forth that is going to be going on this afternoon, I best leave those for your response to the record and at this time will thank you very much for your testimony unless Senator Kasten has other questions. While we are gone, if the next panel could get set up, that would be appreciated. Thank you very, very much.

Mr. KAMATH. Thank you.

Mr. JONES. Thank you.

[Recess.]

The CHAIRMAN. I apologize to all of you for circumstances beyond my control.

Our second panel is already seated. Mr. Altarescu, are you Rumanian by any chance?

Mr. ALTARESCU. My family is, yes, sir.

The CHAIRMAN. A good Rumanian name.

Please proceed.

STATEMENT OF HOWARD S. ALTARESCU, VICE PRESIDENT, GOLDMAN, SACHS & CO., NEW YORK, NY

Mr. ALTARESCU. Thank you.

My name is Howard Altarescu. I am a vice president of Goldman, Sachs and Co. Goldman Sachs is one of the lead investment bankers for the Small Business Administration. As requested, I will try to be succinct and respond to the questions put by the Committee.

The first question was whether the COSBI structure would enable it to serve as a better source of capital for small businesses as compared to the SBIC Program. Our conclusion, as presented in some more detail in our written statement, is that as the COSBI structure would not rely upon congressional authorizations for funding in order to obtain funds for small businesses, we believe that the COSBI Program would, in fact, provide an efficient source of funds relying solely on capital market considerations. While you cannot, of course, always rely on capital market funds being available at efficient levels, certainly from a long-term perspective we believe that the capital markets can provide efficient funds for the COSBI Program and, therefore, for the SBICs.

Second, you have asked whether the sale of the SBIC debenture portfolio to COSBI should be with or without recourse. As the prior testimony indicated, we believe that the proposed transaction could be accomplished either on a with-recourse basis or on a without-recourse basis. We included in our testimony an appendix, appendix A, which sets forth the details of the nonrecourse transactions effected by the Government last year. We think that the transaction can be structured without recourse or, as presently contemplated, with recourse.

Third, you have asked for the view of Wall Street with respect to the securities which would be issued by the COSBI and how those securities would compare with securities issued by other Government-chartered enterprises. There are, obviously, a wide variety of Government-chartered enterprises. The ones most significant we believe for comparison purposes are FNMA and SLMA. We also thought about the differences with GNMA and FHLMC. And we included a chart in appendix B which presents the structural characteristics of those entities and of COSBI. And for the most part, they show similarities, which is to say with the exception of FHLMC, and ignoring GNMA which itself has a full faith and credit guarantee—SLMA, FNMA and FHLMC are all created by acts of Congress. FNMA and SLMA are privately owned, as would be COSBI. FNMA and SLMA and FHLMC are subject to certain levels of Government regulation, as would be COSBI. With the exception of FHLMC, they all have a Treasury backstop, which is to say, authority on the part of the Secretary of the Treasury to provide funds. FHLMC has a special relationship with the Federal

Home Loan banks which at the outset contributed $100 million. So, there is no Treasury backstop there, but we believe that is a clearly distinguishable situation.

With the Treasury backstop, with the other characteristics that are presented in appendix B, we do believe that COSBI securities would be treated as agency securities, and would trade with SLMA and FNMA. And I will explain that more in a moment.

Another feature we looked at, even though we have got an agency security or an agency issuer, is the capital structure itself. As indicated previously, we have a maximum debt-to-equity ratio as proposed of 15 to 1. The projections that have been prepared for COSBI show debt-to-equity ratios not in excess of 7 to 1 which is very conservative especially when compared with the outstanding actual debt-to-equity ratios of FHLMC, FNMA, and SLMA.

Currently, FNMA and SLMA securities—and I'll use a 10-year maturity debenture as an example—carry a cost of 50 basis points or half a point over the comparable Treasury security with a 10-year maturity. By contrast, the current SBA participation certificate which is issued carries a cost to the SBIC's, which have the underlying assets, of approximately 70 to 80 basis points over the comparable maturity, the 10-year maturity Treasury.

The reason for this wide spread is that the SBIC debenture has certain features, again which is presented in detail in the written testimony, which causes uncertainty in the marketplace. These are not credit-related because the SBIC, of course, has the full faith and credit of the Government, but rather a feature is built into the underlying SBIC debentures, acceleration events which result in uncertainty of payments. There is a cost in the market for any uncertainty.

If the COSBI simply continued the program of funding through selling pools of the underlying debentures, and if the underlying debentures were structured as they currently are without the full faith and credit guarantee, there of course would be additional cost. On the other hand, COSBI has in mind other kinds of structures, such as a straight debt structure, like the SLMA and FNMA structures, which would provide significant savings.

So, if you look at a 70 to 80 basis point spread on the existing SBA PC and a wider spread on a COSBI PC, you can compare that to the SLMA or FNMA spreads of 50 basis points, which we think could be ultimately achieved by the COSBI. At the outset when COSBI issues its debt, because the security will be new, because the institution, the entity itself, would be new, we expect that the spread would be wider than SLMA and FNMA, but not in a material way. And certainly we think that it would be tighter or less expensive than the existing SBA PC structure.

Our conclusion in this regard is that the COSBI securities would be viewed as agency securities and that the COSBI securities could be sold at very attractive spreads.

A couple of other final points. The ultimate cost of money to small businesses as clients of SBIC's. Again, so long as the COSBI could structure securities in the way I have outlined, debt securities, fixed maturities, whether it is 10 years, less or longer, we think that efficient financing can be obtained. COSBI could then be in a position to make its program less costly to small business clients of the SBIC.

Finally, on recommendations, two thoughts I would like to pass along. One, in looking at the structural characteristics which are presented out in one of the appendices, the one difference that is evident is that the COSBI Program or the COSBI securities would not trade on the book entry system. There is a cost involved to that when you have to have definitive securities. Usually these are fairly intangible costs. Our traders for the purpose of our own internal analysis estimated a 5 to 10 basis point cost involved. As I say, I call that a soft estimate, but there is a cost involved. So, I would urge consideration of elimination of that cost by permitting the use of the book entry system.

The second and final point, from the point of view of a recommendation, is that both the House and the Senate proposed bills restrict the COSBI from reselling the SBIC debenture portfolio to be acquired from the Federal Financing Bank for 3 years. If those securities could be resold, we think COSBI might be able to derive benefits. In addition, there are certain risks in holding on to long-term assets, and so we would suggest consideration of permitting COSBI to sell all or portions of that portfolio at any time.

Thank you very much.

[The prepared statement of Mr. Altarescu follows:]

Testimony by Howard S. Altarescu, Goldman, Sachs & Co.

United States Senate, Committee on Small Business
Hearing to examine S.1929, A Bill to
amend the Small Business Investment Act

February 24, 1988

My name is Howard Altarescu. I am a Vice President of Goldman, Sachs & Co. Goldman Sachs is one of the lead investment bankers for the Small Business Administration and is one of the leading investment banking firms in the areas of mortgage securitization and non-mortgage asset securitization. Goldman Sachs has also been a co-manager in certain of the recent government asset sales transactions.

Set forth below is a summary statement of our views on specific issues on which the Committee requested comment.

1. How COSBI's structure will enable it to serve as a better source of capital for small businesses than the present SBIC Program.

The present SBIC Program relies upon an SBA full faith and credit guarantee, and the principal amount of securities which may be guaranteed by SBA in any year is limited to the amount specifically authorized by Congress.

This amount was set at $261 million for the fiscal year 1987, beginning October 1, 1986, and originally at $272 million for the fiscal year 1988, beginning October 1, 1987. Since the implementation of the Grahm-Rudman-Hollings Act, however, the fiscal year 1988 authorization has been reduced to $233 million, and the proposed authorization for fiscal year 1989 is $186 million, of which $36 million is directed toward special SBICs which were formerly considered under the separate MESBIC authorizations.

The COSBI structure would not rely upon Congressional authorizations for funding to be obtained in order to provide capital for small businesses. Funding for the COSBI program would be dependent solely on capital market considerations.

2. Is it necessary or preferable that the sale of the SBIC debenture portfolio to COSBI be with recourse?

A full recourse sale of the SBIC debenture portfolio held by the Treasury's Federal Financing Bank would maximize the cash proceeds to the government and would provide COSBI with a more valuable asset for ultimate resale or for use as collateral. However, so long as reasonable estimations could be made with respect to anticipated delinquencies, defaults and losses on the portfolio, a sale without recourse to the SBA may also be possible. A non-recourse sale would give COSBI both downside credit risk and the opportunity to profit in the event that losses assumed for valuation purposes exceed actual results.

This past year the federal government sold three pools of loans on a non-recourse basis. These sales are described in Appendix A. These assets were sold in the form of pass-through participation certificates or collateralized bonds through trusts established specifically for this purpose. In order to enhance the value of the securities sold and to obtain a rating, combinations of subordination, cash reserves and pool insurance were used as substitutes for recourse to the government. The total pricing of each of these sales ranged from 52.9% to 60.8% of the outstanding principal balance of the underlying pool of assets.

3. How will COSBI securities be viewed on Wall Street in comparison with securities of other government chartered enterprises? Observations on COSBI's structure in comparison with other government sponsored enterprises; should it be expected to perform as well as FNMA, Sallie Mae or such other enterprises?

There are a wide variety of government chartered enterprises as well as a wide variety of securities issued or guaranteed by such enterprises. The securities issued or guaranteed by these government chartered enterprises range from common and preferred stock and corporate debt obligations to pass-through trusts, collateralized mortgage obligations, and stripped mortgage backed securities, including interest only (IO) and principal only (PO) securities.

GNMA enjoys the full faith and credit of the United States.

FNMA and Sallie Mae are privately owned corporations, although each is subject to government regulation.

FHLMC is a corporate instrumentality owned by the Federal Home Loan Banks and is also subject to government regulation.

COSBI would also be a corporate instrumentality, but would be privately owned.

Structural characteristics of selected government-chartered entities are shown in Appendix B. In many respects, COSBI's structure is identical to other government-chartered enterprises which have been successfully enabling private lenders to access the capital markets for funding with stability and certainty and without the "full faith and credit" guarantee of the federal government.

As shown in Appendix C, while the total debt to equity ratio for COSBI is limited to 15:1, the actual ratios for FNMA, FHLMC, and Sallie Mae are currently 46:1, 34:1, and 21:1, respectively.

There are certain features in the present SBIC Program which are responsible for wider spreads than government guaranteed debt ordinarily can achieve. These features, each of which is discussed below, are as follows: (a) Optional Prepayment provisions; (b) Acceleration Event provisions; (c) the grantor trust structure; and (d) ERISA limitations on investment by Employee Benefit Plans.

The present SBIC Program provides for the sale of SBA guaranteed participation certificates ("PCs") representing interests in a pool of SBIC Debentures. The PCs provide for the pass-through to investors of principal and interest payments made by the SBICs on the underlying Debentures. Each of the underlying Debentures has a ten year maturity, provides for semiannual interest payments and provides for principal repayment at maturity. Two additional features (the Optional Prepayment and Acceleration Event provisions), however, add a degree of complexity and uncertainty to an otherwise straightforward structure.

Optional Prepayments. First, each Debenture provides for prepayment at the option of the SBIC obligor beginning after the fifth year after issuance. In year six, prepayments may be made at a price of par plus a premium equal to the coupon on the Debentures. For example, the SBA issue of February 10, 1988 had a coupon of 8.85% and the prepayment price in year six would be 108.85%. The premium required to be paid declines ratably in each year thereafter. In the event that an SBIC elects to make an Optional Prepayment, the amount paid is passed through to the investors. While the prepayment premium is quite steep and is likely to fully compensate investors in most circumstances, this is a feature which creates uncertainty and, therefore, has some associated cost.

Acceleration Events. Second, and perhaps more significant, an SBIC's default, under the SBA's regulations, may result in either an automatic or a discretionary acceleration of the SBIC's Debentures. In such an event (which is referred to as an Acceleration Event), the SBA makes a full prepayment of the Debenture which is passed through to investors.

Under its regulations, SBA may, in its sole discretion, declare an acceleration of an SBIC's Debenture upon the occurrence of any one or more of the following: (i) default in the payment of the principal or interest under any debenture, note or obligation of an SBIC, issued to, held or guaranteed by SBA; (ii) non-performance or violation by an SBIC, as determined by SBA, of any one or more of the terms and conditions of any loan or obligation of the SBIC issued to, held or guaranteed by SBA, or any agreement with or condition imposed by SBA; (iii) failure of an SBIC, as determined by SBA, to comply with any one or more of the provisions of the Small Business Investment Act or regulations promulgated thereunder, as such regulations may be amended from time to time; and (iv) failure of an SBIC to notify SBA within 20 days from the date of an event of default or non-performance by the SBIC under any debenture, note or indebtedness of the SBIC issued to or held by anyone other than SBA. Before such an acceleration is declared, SBA's standard operating procedures call for the transfer of the SBIC from operating status to liquidation status.

Notwithstanding the above, SBA regulations provide that a Debenture is automatically accelerated without prior notice to the defaulting SBIC whenever: (i) an SBIC is insolvent; (ii) not having sufficient property to pay all of its debts, an SBIC makes a voluntary assignment thereof; (iii) an SBIC makes any transfer or incurs any obligation that is fraudulent under the terms of 11 U.S.C. §548 (the Bankruptcy Code); or (iv) a petition is filed in commencement of any bankruptcy or reorganization proceeding, receivership, dissolution or other similar creditors' rights proceeding, by or against an SBIC, whichever event shall first occur. Whenever SBA learns of the occurrence of such an event of default it must transfer the SBIC into liquidation status.

The anticipated rate and amount of prepayments of principal, if any, to investors as a result of Acceleration Events cannot be predicted. This uncertainty creates the most considerable cost to the SBICs.

Grantor Trust Status. The two other features which distinguish the present SBIC Program from government guaranteed debt relate to the security's structure as a pool of receivables rather than a direct indebtedness. The securities sold to investors are not direct debt obligations-- are not the SBIC Debentures themselves -- but are interests in a pool of the Debentures. The pool is classified as a grantor trust, which for most purposes means that the investor is treated as having invested in the Debentures directly. However, the indirect nature of the investment is a complexity which may have an associated cost.

ERISA Limitations. Finally, the acquisition of a PC by an employee benefit plan subject to the Employee Retirement Income Security Act of 1974 ("ERISA") could result in a prohibited transaction or other violations of the fiduciary responsibility provisions of ERISA and certain provisions of the Internal Revenue Code if, by virtue of such acquisition, the Debentures were deemed to be assets of the Plan. This ERISA restriction eliminates certain potential investors and may also have an associated cost.

SBA PCs are currently priced at a spread of approximately 70-80 basis points over the ten year Treasury. By contrast, FNMA and Sallie Mae debentures with ten year maturities and which cannot be called during the life of the security are currently priced at a spread of approximately 50 basis points over the ten year Treasury. Although the SBA security has a full faith and credit guarantee, and the FNMA and Sallie Mae securities do not, the structural features discussed above result in the wider spreads for the SBA PCs.

When some of those structural uncertainties are introduced into agency securities, such as GNMA pass-throughs, the spreads also widen for those securities. GNMAs have the benefit of a full faith and credit guarantee but are subject to mortgagor prepayment risk. Mortgagors generally have the right to prepay their mortgage loan without penalty or premium. Such a prepayment would be passed through to the GNMA investors. A GNMA with a 30 year maturity and, based on projected prepayments, a ten year average life would be priced at a spread of approximately 125-135 basis points over the ten year Treasury.

If the COSBI security is structured like the current SBA PC, it should trade somewhat wider than the SBA PC due to the elimination of the full faith and credit guarantee.

A COSBI security structured to eliminate the features which distinguish it from the FNMA and Sallie Mae no-call debenture, and which is issued in sufficient size to establish liquidity, absent unforeseen circumstances, should not trade materially wider than the FNMA and Sallie Mae issues.

4. What costs or savings to the Government may come from this legislation.

The "cost" of the SBA full faith and credit guarantee will be eliminated on additional SBIC related financings.

In addition, COSBI, which will be essentially privately owned, will take over many of the administrative responsibilities and financial risks of the SBA. COSBI will be empowered to qualify SBICs, to oversee the operations and standards of qualified SBICs for lending to small businesses, to provide payment guarantees on the securities issued by qualified SBICs, and to make advances on the security of, purchase or repurchase, service, sell or resell, and offer participations or pooled interests or otherwise deal in small business investment securities. All the expenses associated with doing such business will be borne directly by COSBI rather than the federal government through the SBA.

5. Is it anticipated that the ultimate cost of money to small businesses as clients of SBIC's will be greater or less than under the current program?

COSBI PCs will carry wider spreads than comparably structured SBA PCs due to the elimination of the SBA guarantee. In addition, there is no servicing charge to the SBICs in connection with the SBA program. Although the proposed COSBI program may provide more certainty of funding and perhaps other advantages, if the cost of the wider spread, servicing and/or other costs are passed along, the proposed COSBI program may be more costly to the small business clients of SBIC.

On the other hand, to the extent that COSBI uses debt to finance its operations, as indicated elsewhere, ten year non-call COSBI debt, absent unforeseen circumstances, should not trade materially wider than ten year non-call FNMA and Sallie Mae debt, which trades at a spread of approximately 50-65 basis points over the ten year Treasury. This is compared to COSBI PC spreads estimated at in excess of 70-80 basis points over the ten year Treasury. COSBI could then be in a position to make its program less costly to small business clients of SBIC.

6. What recommendations or changes would you suggest to the Committee?

The proposed legislation would prohibit COSBI from selling for three years the SBIC debenture portfolio to be acquired from the Treasury's Federal Financing Bank. As presently proposed, $200 million of the estimated $720 million purchase price will be funded by preferred stock, with the remainder funded by debt. Accordingly, during this three year period, COSBI would have the risk of owning assets which are subject to Acceleration Events while having long term debt outstanding. We would suggest consideration of permitting COSBI to sell all or portions of this portfolio at any time in the form of PCs or in other structured financings.

APPENDIX A

RECENT NON-RECOURSE ASSET SALES BY U.S. GOVERNMENT

Seller	Asset	Issuer	Issue Date	Rating	Credit Enhancement	Recourse	Structure (Dollars in millions)					Total Price/ Outstanding Principal of Assets
Farmers Home Administration	FmHA loans to local governments and not-for-profit corporations to finance utility and public service improvements. Average loan size is $300 thousand; 40% of outstanding principal is loans over $1 million.	Community Program Loan Trust 1987A	9/87	Aaa/AAA (Sr)	7% Subordination. $10 million reserve fund. Residual cash flows remain in Trust.	None	Multi-Class:					58.6%
							Class	Amount	Coupon	Maturity	Price	
							A-1	$ 245	4.50%	4/96	87.80%	
							A-2	116	4.50	10/97	73.85	
							A-3	204	4.50	10/02	65.94	
							A-4	1,031	4.50	10/18	51.73	
							A-5	203	4.50	4/29	48.25	
							B	135	4.50	10/28	53.93	
								$1,934				
Farmers Home Administration	$2.969 billion pool of mortgage loans to rural, low- and moderate-income borrowers originated between 1973 and 1985. Individual loan sizes range from $7,500 to $50,000 with interest rates from 6% to 11%. LTVs at origination up to 100% at origination and up to greater than 100% at sale. Borrowers rights include "Interest Credit" to reduce rate to as low as 1%, up to two years moratorium on P&I repayments, reamortization of outstanding loan amount, and extensive review before foreclosure.	Rural Housing Trust 1987-1	9/87	Aaa/AAA	25% Subordination. (Retained) Timely payment of P&I no slower than a prescribed schedule guaranteed on a several basis by three members of American Loan Guarantee Association: Financial Guaranty Insurance Company, Financial Security Assurance, and Municipal Bond Investors Assurance Corporation. Scheduled payments are exclusive of special hazard losses over $30 million.	Interest credit on loans paid by FmHA to Trustee	Multi-Class:					59.6%
							Class	Amount	Coupon	Maturity	Price	
							1-A	$ 194	6.33%	6/94	98.6%	
							1-B	127	6.33	6/97	83.2	
							1-C	179	6.33	8/00	75.3	
							1-D	816	6.33	4/28	67.2	
							2-A	105	6.83	5/94	94.8	
							2-B	284	6.83	10/02	78.5	
							2-C	284	6.83	4/26	70.0	
							3-A	154	7.33	2/01	87.8	
							3-B	203	7.33	4/26	73.3	
							4-A	135	8.33	2/05	88.4	
							4-B	130	8.33	4/26	78.8	
								$2,375				
U.S. Department of Education	$237 million of loans to colleges and universities for the construction, rehabilitation, and improvement of buildings. Average outstanding balance per loan is $732 thousand, ranging from $20 thousand to $7,595 thousand. Weighted average interest rate is 3.16%, ranging from 2.75% to 3.75%. Weighted average maturity is 19.4 years, ranging from 2 years to 37 years.	College and University Facility Loan Trust One.	9/87	Aaa/AAA	46.5% subordination. (Retained) $2.6 million liquidity fund.	None	Multi-Class:					52.9%
							Class	Amount	Coupon	Maturity	Price	
							1	$12.0	8.50%	12/89	99.8%	
							2	10.1	9.20	12/91	99.9	
							3	12.3	9.70	12/93	99.7	
							4	55.0	10.20	6/02	99.3	
							5	37.6	10.55	12/14	99.4	
								$127.0				

APPENDIX B

STRUCTURAL CHARACTERISTICS OF SELECTED GOVERNMENT-CHARTERED ENTITIES

Structural Characteristics	Federal Home Loan Mortgage Corporation ("Freddie Mac")	Federal National Mortgage Association ("Fannie Mae")	Student Loan Marketing Association ("Sallie Mae")	COSBI Provisions
1. Government Financial Support	No Treasury backstop	Treasury has discretionary authority to purchase obligations equal to $2.25 billion. Federal Financing Bank can loan up to $5 billion in long-term borrowing, which is currently fully-exhausted	Treasury has discretionary authority to purchase obligations equal to $1 billion. Federal Financing Bank must loan up to $5 billion in long-term funds, which is currently fully-exhausted.	Treasury has discretionary authority to purchase obligations equal to $500 million, subject to Congressional appropriation
2. Creation	Act of Congress	Act of Congress	Act of Congress	Act of Congress
3. Directors Appointed by the President	Three directors appointed by the President with the advice and consent of the Senate	Five directors appointed by the President. Stockholders elect two-thirds.	One-third of board of directors is appointed by the President. President also designates chairman.	5 of 15 directors appointed by President
4. Agency Oversight	Federal Home Loan Bank Board	Housing and Urban Development	No	Small Business Administration
5. Borrowings Approved by Treasury	Yes	Yes	Yes	Yes
6. Form of Transfer	Book Entry	Book Entry	Book entry	Not book entry
7. SEC Registration	Exempt	Exempt	Exempt	Exempt
8. State and Local Tax	Not Exempt	Not Exempt	Exempt	Exempt

APPENDIX C

CAPITALIZATION OF GOVERNMENT-CHARTERED ENTERPRISES

(dollars in millions)

	Federal National Mortgage Association ("Fannie Mae")	Student Loan Marketing Association ("Sallie Mae")	Federal Home Loan Mortgage Corporation ("Freddie Mac")	Corporation for Small Business Investment ("Cosbi")
As of:	9/30/87	9/30/87	12/31/86	pro forma
Total Assets	$99,612	$22,574	$21,210	$3,520 (1)
Total Borrowings	97,478	21,929	20,257	3,300 (2)
Total Equity	2,134	645	953	220 (3)
Borrowings/Equity	45.7x	34.0x	21.3x	15.0x (4)

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(1) Based on sum of Total Borrowings and Total Equity.

(2) Based on maximum Debt/Equity of 15.0x.

(3) Based on $20 million in capital contribution from qualified SBICs and $200 million in preferred stock as a result of the FFB sales transaction.

(4) The maximum leverage ratio allowable according to the proposed legislation.

The CHAIRMAN. Thank you. That is a very interesting and instructive statement.

Mr. ALTARESCU. Thank you.

The CHAIRMAN. Mr. Philip.

STATEMENT OF ROBERT W. PHILIP, AUDIT PARTNER, ARTHUR ANDERSEN & CO., DALLAS, TX

Mr. PHILIP. Mr. Chairman, I appreciate this opportunity to testify before this Committee on the involvement Arthur Andersen has had with the prospective financial information prepared to assess the financial viability of COSBI. And I further commend you and this Committee on its willingness to hold these hearings on S. 1929 which would create COSBI if it is enacted.

I have submitted a written statement for the record and will just very briefly summarize several things that I think are important from that statement.

To illustrate the diligence with which the industry and Members of this Committee have considered alternatives as to the creation of COSBI and its various financial attributes, our involvement with this process started in December 1986 a little over a year ago when we were asked as a public service to work with NASBIC staff in developing financial projections for COSBI if it is created. Since then, I haven't kept up with the time that we've put in it, but I know that the NASBIC staff, the COSBI transition committee, other members from the SBIC industry, and members of your staff have spent hours considering the alternative ways in which COSBI might be financially structured and operate, if it is created under this legislation.

What we have done in that regard is, first of all, build a computer framework to catch the assumptions, the "what if" questions, and process them through to show what the financial results of these various alternatives might be. We have also worked with the industry and with the staff of this Committee in assembling information to be used in support of the various operating assumptions that have been made for COSBI. In doing that, we have not been silent on our opinion as to whether those assumptions are reasonable as they are put together. And then finally, we have compiled the data that is included in the executive summary submitted by Mr. Jones with his testimony earlier this afternoon.

It is important when you look at hypothetical financial information, projections, prospective financial information to make note that they are based on assumptions and they are hypothetical. And reality very frequently does not reflect those assumptions as made.

I think it is also important for me to point out that the industry representatives who are supporting the COSBI concept and who would be operating COSBI have accepted responsibility for the assumptions that were made. And the reason I think that is important—you've been in business; I've been in business—is that it doesn't do a lot of good for the accountant to show up with a business plan when the entrepreneur goes to the bank and wants to borrow some money. What is important is for the entrepreneur to understand what that business plan is, what has gone into it, and accept responsibility for trying to live up to it. And the industry representatives have done that.

Our conclusion as we have been involved in this whole process—and my recollection is it involves more than 200 passes through the computer as to what COSBI might look like under varying conditions—is first, and probably most important, that the projections you've received do reflect the assumptions that you have also received in that they have been processed properly.

And second, in our opinion, the assumptions used to put this prospective financial data together are reasonable. We did not see in our work with the industry and our work with any Members of your Committee staff, any assumptions that wound up in the projections selected by industry as most likely to be what would happen, anything that we thought was an unreasonable or an inconsistent assumption within the prospective financial data.

Having said that, and recognizing that Mr. Jones testified very articulately on the operating results of COSBI under these assumptions, let me just point out a couple of things.

The 15-year prospective financial data looks good on day 1. It looks good at the end of year 15. It also looks good every intervening year. So as you look at the beginning results and at the results at the end, you can be assured that these projections have no big dip in the middle that would require any attention either from the Government or from the private sector.

For example, by the end of the 5th year, COSBI's equity would have built up from its original $220 million to $250 million. It builds up at the end of the 10th year to $280 million. It builds up at the end of the 15th to $303 million of equity. Cash balances are similarly built up over the period—in the 5th year, $278 million; 10th and thereafter, in the $300 million range.

So, while I cautioned about the likelihood that reality will be different from assumptions, COSBI has built in some pretty significant cushions to cover anything on the downside that might happen vis-a-vis the assumptions that are put together with this rather large equity balance and these rather large cash balances going forward. As has been mentioned, the debt-to-equity ratio initially is about 2½ to 1. It winds up not quite 7 to 1 and is never any higher during the 15-year buildup period than the final 6.6 to 1.

Another thing I think is interesting and it is in a partial response to one of the questions you asked about what would be the cost to the Government or savings if COSBI is created is that these projections show that there would be no cost to the Government. There would be no out-of-pocket cost to the Government. There would be considerable savings in the operation of the financing and regulatory function moving from the public to the private sector, and that has been pointed out.

A couple of things that haven't been pointed out is that these projections indicate that, in the 15-year period that they cover, the Government will receive dividends of $50 million on the preferred stock that it receives as part of the purchase of the initial portfolio, and the Government will receive something over $40 million in Federal income taxes at current rates from COSBI's successful operations going down the road.

The **Chairman**. I want to be sure I understand that point, Mr. Philip. Are you saying that is in excess of what they now receive from SBIC financed corporations?

Mr. **Philip**. That is in addition to what they now receive.

The **Chairman**. You are saying it's an additional $40 million a year in taxes?

Mr. **Philip**. An aggregate in the 15 years of $40 million.

The **Chairman**. In excess of what they are getting now.

Mr. **Philip**. That's correct, plus the $50 million in dividends that I mentioned.

So, we have concluded, as to the viability of COSBI, that the projections are properly put together, that the assumptions are reasonable, and that if COSBI does become created and operates in accordance with these assumptions, it can be a financially viable operation.

A legitimate question would be, well, all right, that may be, but what are the assumptions that, if incorrect, would have the greatest negative impact on COSBI's future operations. And there really aren't but two or three.

One is if the eventual legislation enacted to create COSBI is vastly different from the financial aspects of the bill that has been introduced, whatever that difference is would, of course, have an impact on COSBI's future operations.

The second thing that could have a significant impact would be the prospective growth of the SBIC industry. It is important that, as the initial portfolio purchased by COSBI is liquidated and collected, new financings and new leverage to the SBIC industry take place in order to create an asset base for COSBI to handle its regulatory and financing functions. So, if the SBIC industry does not grow as projected, that could have a serious negative impact on the future viability of COSBI.

The third and final thing that could have a very significant impact on COSBI's future operating results is whether it is able to manage its future leverage funds and collect them with losses no greater than are considered in the projections. The projections consider a 20 percent default rate with an eventual 8 percent actual loss rate. Obviously, if that loss rate were 16 or 20 or 30, that would have a pretty big impact on COSBI's actual operating results.

I have been asked a question in other forums as to what that means. What it means is that, in the private sector, COSBI supporters believe that operated as COSBI is intended to operate, it will do a better job than has the SBA in assessing credit and monitoring the activities of SBIC's and in collecting the leverage money that has been put out.

Mr. Chairman, having seen 200 of these sets of prospective financial data and having seen the industry representatives, after considerable consultation with this Committee's staff, select the one that is included in this executive summary as most likely, I would have to conclude—after 30 years' experience in my profession observing business plans being put together, observing financial plans being put together, observing individuals wanting to start a new enterprise receiving consultation as to what a good operating plan would be from various sources—that the COSBI Transition Committee of the industry group has done as solid a job as I have seen of trying to anticipate both the up side and the down side and trying to be conservative, where there was an opportunity to be conservative, in the assumptions that they made.

I would be glad to respond to any questions.

[The prepared statement of Mr. Philip follows:]

ARTHUR
ANDERSEN
&CO.

STATEMENT OF ROBERT W. PHILIP

ON BEHALF OF

ARTHUR ANDERSEN & CO.

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

HOLDING HEARINGS ON

S. 1929
A BILL TO CREATE A
CORPORATION FOR SMALL BUSINESS INVESTMENT

FEBRUARY 24, 1988

1666 K Street, N. W., Washington, D.C. 20006 Telephone (202) 862-3208

Statement of Robert W. Philip
February 24, 1988

Good afternoon, Mr. Chairman and Members of the Committee: I am Bob Philip, a partner in the Dallas office of Arthur Andersen & Co. I direct our Firm's activities that support national public policies to encourage developing entrepreneurial enterprises. I am also a director of National Small Business United here in Washington, and serve as a member of the Small Business Advisory Council of the Federal Reserve Bank of Dallas.

Thank you for inviting us to testify today on our work with industry and Congressional staff related to the prospective financial information prepared to assess the financial viability of a Corporation for Small Business Investment (COSBI). Subsequent to the preparation of this data, S.1929, the Corporation for Small Business Investment (COSBI) Charter Act, was introduced to provide a mechanism to create COSBI as a privately owned, privately managed corporation subject to government oversight. We commend the Committee for its willingness to conduct these hearings.

Arthur Andersen & Co. has been working with members of the National Association of Small Business Investment Companies, with industry representatives and with your Committee's staff for more than a year to develop prospective financial information for COSBI. In providing our assistance in preparing prospective financial information for COSBI, we received input from industry, and we have also responded to issues your staff raised. COSBI's future financial condition and prospective operating results, if it is created in accordance with the proposed legislation, were the major focus of our work.

Arthur Andersen & Co. has provided this assistance as a public service. It is part of our continuing effort to use our Firm's skills to assist the public sector in strengthening the small business segment of our economy. Arthur Andersen & Co., one of the "Big 8" accounting and consulting firms, has, since 1940, devoted significant resources to the unique needs of this country's small business community. Our firm has one of the largest client bases among small business in the country, which it serves through its network of 80 offices across the United States. We realise that new, small, and growth oriented businesses are highly sensitive to legislation and regulations.

Arthur Andersen & Co. became involved with preparing prospective financial information for COSBI in December 1986, at the request of the COSBI Transition Committee of the National Association of Small Business Investment Companies. We first designed a computer framework to process assumptions regarding COSBI's proposed operations to provide prospective financial information that could be used by the industry to assess COSBI's financial viability.

We have met frequently with industry representatives, investment bankers and Congressional staff members to address the COSBI concept. As input was received from these sources, we entered it into the computer framework, generating numerous sets of prospective financial information reflecting the various approaches and assumptions that were suggested. Also, as members of industry interacted with interested members of Congressional staffs, we received their comments and questions and processed them through the computer framework, as well. In all, scores of iterations were produced for consideration by industry and Congressional staff. All of this was done to provide prospective financial information to be used to craft the legislation that has now been introduced.

This entire process produced the prospective balance sheets, income statements and statements of cash flow summarized in "COSBI, the Corporation for Small Business Investment, an Executive Summary" prepared by the COSBI Transition Committee of the National Association of Small Business Investment Companies, whose names are listed on the cover. It is the blue covered document that industry representatives have already introduced. While I will refer to this document during my testimony, I should point out that the Executive Summary and the assumptions used for the financial projections were prepared by, and are the responsibility of, the COSBI Transition Committee.

Arthur Andersen & Co.'s participation in the project included assistance in designing and developing the computer framework to process the assumptions into prospective financial information, assistance in assembling the prospective financial information, and assuring that the prospective financial information reflects the assumptions selected by the COSBI Transition Committee. The Transition Committee selected assumptions to reflect conditions it expects will exist and the course of action it expects will be taken if COSBI is created. Our compilation of this prospective financial information includes the procedures that we considered necessary to evaluate both the assumptions used by the COSBI Transition Committee (summarized in

Appendix 4a of the Attachment) and the preparation and presentation of the information shown in Appendix 4b of the Attachment.

The prospective financial information assumes that a Corporation for Small Business Investment (COSBI) will be created through legislation similar to that before this Committee. We prepared the information expressly for consideration by the industry and the staff of the appropriate Congressional committees in crafting this legislation. Accordingly, the prospective financial information should be used only by those who are well-informed about the proposed creation of COSBI.

In our opinion, the prospective financial information referred to above is presented in accordance with the assumptions summarized in Appendix 4a, and the underlying assumptions of the COSBI Transition Committee provide a reasonable basis for this presentation, assuming the creation of COSBI through legislation, as described in the assumptions. Of course, even if COSBI legislation is enacted, actual results will differ from prospective results, because events and circumstances frequently do not occur as predicted, and these differences may be material.

Our Firm's projections were completed before S. 1929 was introduced. We have been informed that the prospective financial information reflects the relevant provisions of S. 1929, but we have not undertaken to confirm that conclusion, or to up-date our work to account for any other events or circumstances that might have occurred since we finished our work.

The COSBI Transition Committee accepts responsibility for the assumptions underlying the prospective financial information. Many of these assumptions, including the chartering of COSBI, are necessarily hypothetical, though they remain consistent with the purpose of the prospective financial information.

The prospective financial information indicates that COSBI can become a viable entity if the enabling legislation is enacted and COSBI operates in accordance with the assumptions used to prepare the prospective financial information. For example, this information reflects the following financial results at the end of COSBI's fifth, tenth and fifteenth years:

		(In Millions)	
	5th Year	10th Year	15th Year
Total assets	$1,883.8	$3,542.7	$4,035.5
Equity	249.7	281.2	303.0
Cash	278.0	309.2	313.5
Debt/Equity ratio	4.4:1	6.2:1	6.6:1

During the fifteen years included in the prospective financial information, dividends aggregating more than $50 million would be paid on the preferred stock to be issued in connection with COSBI's purchase of the initial loan portfolio. Federal income taxes in excess of $40 million would be provided by COSBI, based on current tax rates and COSBI's projected operating results. COSBI's initial debt to capital ratio would be 2.4:1, and this ratio would not exceed 6.6:1 during the 15-year projection period.

As indicated earlier, any prospective financial information is likely to differ from actual results because events and circumstances contemplated in the prospective financial information often do not occur as expected. Changes in the principal assumptions or hypotheses that could most affect COSBI's future financial results would be:

- Any significant differences between the enabling legislation and the assumptions used in the prospective financial information to reflect the contents of that legislation.

- The actual future growth of the SBIC/MESBIC industry and the volume of new financings which support that growth. Future financings are important to replace the initial portfolio as it liquidates, providing an income stream for COSBI's continued operation.

- The real loss rate on future financings by COSBI, for which an assumption of 8 percent has been used. The actual loss rate on the initial portfolio is not as significant a factor in the projections, since the projections assume that the initial portfolio is purchased by COSBI "with recourse." This means that the government will share in any liquidation realizations or losses in excess of those assumed by the projections.

- Variations in other assumptions or unanticipated future events or conditions could also affect COSBI's actual financial results. In our judgment, however, the key variables described above appear to be the most sensitive ones, based on our review of all the assumptions and variables selected by both the industry and Congressional staff.

In conclusion, Mr. Chairman, our work with the industry and our responses to questions raised by Congressional staff members have been extensive. This interaction has resulted in consideration of scores of sets of prospective financial information for COSBI, reflecting the varied results of numerous alternative operating hypotheses and assumptions. The prospective financial information included in the attachment have been selected by industry representatives, in consultation with members of your staff, as representing the most likely combination of assumptions and hypotheses that would exist if the COSBI legislation were enacted.

I will be pleased to answer any questions you may have about our work.

The Chairman. Thank you, Mr. Philip.

Mr. Altarescu, as a financial consultant, would you advise a client to invest in any debentures to be issued or even equities that might be issued by COSBI as a good, sound investment?

Mr. Altarescu. Let me focus first on the debentures. Certainly the debentures, with the business plan that has been proposed, and based on the projections—I think looking at the company itself we have a fairly sound company. Looking at the debt-to-equity ratio we have a fairly sound company. But over and above that, we have a corporate instrumentality of the Federal Government with agency status in many respects, a $500 million Treasury backup, to use that shorthand despite the fact that we have the additional clause that subjects the Treasury's input of money to specific congressional authorization, which is unlike FNMA and SLMA. With all of that taken into account, yes, we view this as an investment that we would, in fact, purchase for the purpose of underwriting in the same way we purchase FNMA and SLMA securities. And we think the pricing would be substantially equivalent, as I've mentioned.

Equity is a different matter. I have not, in fact, studied that question to determine whether or not we would underwrite equity, which is equivalent to saying advise clients——

The Chairman. But you would underwrite debentures.

Mr. Altarescu. Yes, we would.

The Chairman. I think one of you may have testified—and I was just sort of perusing your testimony as you spoke, but I may have missed it. What is the difference in the spread, if you underwrite these, if they are with recourse as opposed to without recourse? The calculations I assume take that into consideration.

Mr. Altarescu. Well, let me just clarify. There are two different structures as well. The current structure of the SBA Program is one in which the underlying SBIC debentures are put into a pool and sold as a pool with recourse to the Government. Those pools are sold at spreads of 70 or 80 over the 10-year Treasury. That is even though it has got a full faith and credit guarantee.

So, let's keep in mind 70 to 80 over and just for the moment compare it to a FNMA 10-year security which has a spread of 50 over or a SLMA as well. Neither FNMA nor SLMA has a full faith and credit guarantee, but they raise funds cheaper for the following reason—well, a couple of reasons actually. There are four that were presented in the written testimony.

One, the SBIC's have an optional prepayment right. And so, the investor, the debenture investor, can have his bonds called. That's an uncertainty.

Second, there are acceleration events. So, if the SBIC becomes insolvent or otherwise violates the SBA's regulations, then there are either voluntary or mandatory defaults which results in the SBA paying off those debentures early. And that is a fairly random pattern. So, here too the participation certificate investor has tremendous uncertainty. That is the biggest cost.

Then there are some other technical issues. These are structured as pools and not as straight debt, so you have got to think about some tax issues. And there are also difficulties for pension plans to invest because of the ERISA statute, and all of that is laid out. Those are uncertainties. The biggest one is the acceleration event.

By contrast, if COSBI without full faith and credit went out and issued a 10-year debenture without any call provisions, we think that it would be at the 50 or—the projections use 65 as a spread—50 to 65 basis point spread.

The Chairman. Would you like to comment on that, Mr. Philip?

Mr. **Philip**. Yes. The bottom line on that is covered in the executive summary that Mr. Jones submitted, and that is using a 65 basis point spread over 10-year Treasuries and retaining a 1 percent spread in COSBI, the cost to the SBIC's of leveraged funds would be 20 or 30 basis points over the cost of the SBIC's of the September 1987 financing. But as my colleague has testified, he believes that that can be packaged and structured in a way that the 65 basis point spread assumption is higher than need be going forward. So, the bottom line is that the financial projections show that the cost of leverage money to an SBIC would be nominally more than the present cost. But Goldman Sachs seems to think they could work on that a little bit and get it down equal to or less than the present cost.

The **Chairman**. Now, here you have a pretty good size corporation being set up. You are talking about $700 million. They are going to buy the Federal Financing Bank's portfolio of $700 million. And we are going to take $200 million of that in preferred stock—the Government is. Bear in mind, I have to represent the taxpayers no matter how strongly I may feel about the advisability of this. And the industry is going to have $20 million invested. We have to be honest about it. That's not very much in the scheme of things.

Do you think that still represents a good investment for the Government, Mr. Philip or Mr. Altarescu?

Mr. **Altarescu**. Let me answer it in the context of what the $200 million represents. As I understand some of the deliberations, if the assets that we are talking about from the Federal Financing Bank were sold without recourse, there are projections in the executive summary that was referred to which indicates—let's call it—approximately a $200 million discount would be appropriate for anticipated delinquencies, defaults, foreclosures, losses, and so on. And for whatever the sensitivity there is to Government asset sales with and without recourse, in the three that were accomplished last year, there were substantial discounts for the fact that that assets were sold without recourse. And that too is laid out in one of the appendices.

So, what the preferred stock represents is approximately the difference between the value of that portfolio with and without recourse. If it is transferred with recourse and the Government retains the risk, this is the way the Government is being paid for that risk.

Is that a good investment? Well, I'm sure that a lot of pencils will be sharpened between now and the time legislation comes into being, and the actual amount of the purchase price will be the subject of further evaluation and, if I recall the legislation, potentially three different investment bankers. I think that ultimately the purchase price reflected in the preferred stock will represent fair value to the Government.

Mr. **Philip**. Mr. Chairman, the way that I look at that, the Government is receiving $200 million plus the warrants, plus an opportunity to share in any cash collections on the existing portfolio above the investment banker-determined value discounted as if without recourse. And what that is costing is the Government's willingness to participate in any collections less than the discounted amount. It does not look like a bad deal to me from the standpoint of the Government.

The **Chairman**. Say that a different way. I'm not tracking.

Mr. **Philip**. OK. We're talking about a trade off on "recourse" versus "nonrecourse." "Nonrecourse," whatever the number is, would require a significant discount from the interest adjusted market value that "with recourse" will bring. And so, there is a trade involved. And to me the trade is this: The Federal Government accepts the responsibility for any actual collections that turn out to be less than the discounted amount of the initial portfolio. So, if COSBI collects less than the cash price for that portfolio, the shortfall is "with recourse." So, that is what the Government might have to pay. What the Government get's is the $200 million of preferred stock, the warrants, and the opportunity to participate in any collections in excess of the estimated amount.

The **Chairman**. There is one thing I am not sure about the bill and that is at what point COSBI issues equities—they issue stock.

Mr. **Altarescu**. The $20 million to the SBICs?

The **Chairman**. OK. I go over this bill, and I get it firmly fixed in my mind. Then 2 months go by and I have to try to regurgitate it all.

Mr. **Philip**. You're not alone.

The **Chairman**. You don't know how reassuring that is to me.

One other question. Do you think the makeup of the board—either one of you or both of you—is a factor in the salability of debentures?

Mr. **Altarescu**. Again, I refer you to appendix B, and thanks to your counsel, I have gotten it straightened out. We gave her a new copy with a correction.

In each of the comparatives, the FHLMC, FNMA and SLMA, there are board members appointed by the President. Well, the entire board of FHLMC is the Federal Home Loan Bank Board; FNMA, 5 directors; and one-third of SLMA; and 5 of the 15 directors of COSBI. We had indicated three, but that was corrected.

When I went down to the trading floor at Goldman Sachs after discussing with others at Goldman Sachs who are close to the SBA and who have been close to development of the legislation—and I went down to the trading floor and I talked to the agency traders. They asked a number of questions about the links to the Government and its agency status. Interestingly, they did not ask about the board. That's on the trading floor. But when discussing it with my other colleagues on the finance side, we thought that there was a degree of Government oversight by having board members appointed by the President which we took comfort in. So, I believe that does, in fact, enhance the marketability.

The **Chairman**. Gentlemen, we may and probably will issue some additional questions to you to ask you to answer in writing.

Mr. Philip, I notice in your testimony that you helped COSBI prepare the proposal without charge as a public service, which is always commendable. Do you do that very often?

Mr. **Philip**. Senator, our clients in the great State of Arkansas contributed to our ability to do that. We do try to select one or two rather major issues in the public sector a year that would affect small business, and yes, we do routinely make investments of this nature.

The **Chairman**. Sort of pro bono work, as lawyers say.

Mr. **Philip**. Yes, that's right.

The **Chairman**. Thank you both very much. Your testimony was excellent. I enjoyed it immensely.

Mr. **Philip**. Thank you, Mr. Chairman.

Mr. **Altarescu**. Thank you.

The **Chairman**. Our last witness today is Arthur D. Little, managing director, Narragansett Capital Corp. from Providence.

STATEMENT OF ARTHUR D. LITTLE, MANAGING DIRECTOR, NARRAGANSETT CAPITAL, INC., PROVIDENCE, RI

Mr. **Little**. Would you like me to fire when ready?

The **Chairman**. Yes, please.

Mr. **Little**. I am Arthur Little. As you mentioned, I'm managing director of Narragansett Capital, Inc. in Providence, RI. And I, indeed, have been in and around venture capital business—well, I've been in venture capital business for 21 years. I have been around it since 1959 because actually my father, Roy Little, started the Narragansett Capital organization, and so I have kind of got a few things by osmosis as well.

I have been in the same position that Dave Jones was in. We at that time called it president of NASBIC and now chairman, and I am currently serving on the board of the National Venture Capital Association.

I would just like, as you suggested, to submit my written statement. And I have included with my written statement two written statements by other members of the NVCA board, a gentleman by the name of Rick Burnes and a fellow by the name of Jack Curtin. I did that in particular because their testimony emphasizes the need for both SBICs and venture capital companies that are organized as partnerships because there is such a wide variety of companies that need to be financed in this country.

In the venture capital community and the people who raise money institutionally for private partnerships—they tend to invest in companies that will not withstand debt. They tend to look at things that are very risky and in Rick Burnes' terminology are home runs; whereas, with my background in the SBIC business, we tended to invest in things that were at a later stage and perhaps less risky, had cash flow, but really needed capital to continue their growth. And the SBIC Program was really, frankly, perfect for that kind of financing.

I'd really like to make a couple of points from my written testimony and just concentrate on those. If you look back historically, I think you can make a very good case that the SBIC business, starting with the act in 1958, really was the groundswell for the venture capital business in this country. Before that, you had rich families and one particular company, American Research and Development, which were really the only institutional people in the business. The SBIC business really institutionalized the venture capital business. It gave a great many of us the opportunity to learn the business from the SBIC venue, and it gave enough track record for institutional investors, like insurance companies and pension funds and university endowments, to see that there was a track record that venture capital investing really was a good business.

So, what you really did was got the business going with the SBICs, but if you look at the facts recently, what you will see is that the SBICs have gradually been eclipsed by the growth of the venture capital private partnerships.

In my estimation there are a number of reasons, but there is one overwhelmingly main reason, and that is the issue of uncertainty. If you listened to the gentlemen, as I know you did, from the financial community, there are a couple of key times when they used the word "uncertainty. 'If you are in the financing business, you can stand bad news, you can stand a lot of good news, but uncertainty you really can't deal with because there is just no way that you can make your plans. What you have had in the SBIC business is uncertainty due to not knowing whether financing borrowing would be available and if so, in what amounts it might be available. You have had uncertainty in terms of knowing whether the SBA was going to be around and, therefore, whether the SBIC business in itself was going to be around. And you had a tremendous amount of uncertainty, and inconsistency I might add, with the SBA in their rulemaking in the way in which they have regulated the industry.

It is interesting to me to note that during the early parts of the SBIC industry when there should have been, as there is in the case of all new businesses, cause for the greatest concern, there really was a spirit of the maximum amount of cooperation. Now that the SBIC business has really I think proven itself, interestingly enough, instead of the noose loosening, the noose has become tighter and standards have been more irregularly put forth.

The specific instance I have in mind is the whole issue relative to control or non-control of small businesses. And in my memory the SBA flopped back and forth on that one at least five times. It's very hard to know when you are putting up practically all of the financing for a business whether you are going to be able to control or not control and whether you can do that through stock ownership or you have to do that through debt financing, and so forth.

So, I would urge you that I think that COSBI does more than anything else that I have heard of to remove the uncertainties from the business.

I would further urge you, as Mr. Jones did, to remove the SBA as much as possible from the day-to-day oversight and rulemaking. I think that is incredibly important.

Just on a personal note—and I think this is probably the easiest way to sell you on the strength of what you are doing here. My wife, who has significant amount of experience in the early stage venture capital business herself, has talked and I have talked for some period of time about the possibility of her starting an SBIC. And I have told her that I would be happy, along with her own funds, to provide equity capital for that. And our decision point is very simple. If this bill gets passed on a straightforward basis, I would say that there's a very, very good chance that we will go ahead and start that SBIC. If it is not, we won't because there is just too much uncertainty. And so, I think from my point of view, if you want to talk about where the rubber meets the road, those are the kinds of decisions that you are making.

The benefits of being in the SBIC business is that you get the advantage of leverage. The price that has been paid up until now has been really the regulation by the SBA and the uncertainty. If you remove those uncertainties, the real beneficiaries will be people who want to start businesses, who want to expand businesses, and really the SBIC kinds of businesses. And I think if there is one central thing that those businesses do is that they create jobs like mad.

Thank you.

[The prepared statement of Mr. Little follows:]

February 24, 1988

STATEMENT OF
Arthur D. Little

before the
COMMITTEE ON SMALL BUSINESS
OF THE
UNITED STATES SENATE

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

IT IS A PLEASURE TO APPEAR BEFORE THE COMMITTEE TO SUPPORT S 1929. IT IS A BILL WHICH IS MOST IMPORTANT TO FUTURE FUNDING FOR SMALL BUSINESSES.

I AM ARTHUR D. LITTLE, MANAGING DIRECTOR OF NARRAGANSETT CAPITAL, INC., OF PROVIDENCE, RHODE ISLAND. I HAVE TWENTY-ONE YEARS OF EXPERIENCE IN THE VENTURE CAPITAL BUSINESS. THROUGH THE END OF 1986, I WAS CHAIRMAN OF THE BOARD OF NARRAGANSETT CAPITAL CORPORATION, WHICH WAS STARTED IN 1960 AS AN SBIC. WE WERE THE LARGEST PUBLICLY-OWNED SBIC AND THE FIRST TO DRAW DOWN THE MAXIMUM $35 MILLION IN LEVERAGE. I HAVE ALSO BEEN THE CHAIRMAN OF NASBIC AND AM CURRENTLY ON THE BOARD OF THE NATIONAL VENTURE CAPITAL ASSOCIATION.

GENERALLY SPEAKING, THERE ARE TWO KINDS OF VENTURE CAPITAL COMPANIES -- VENTURE PARTNERSHIPS WHICH RAISE CAPITAL FROM INSTITUTIONAL SOURCES TO INVEST EQUITY IN EARLY-STAGE TECHNOLOGY

COMPANIES, AND SBIC'S WHICH RAISE SMALLER AMOUNTS OF MONEY FROM A VARIETY OF SOURCES AND BORROW MONEY THROUGH THE SBIC PROGRAM TO MAKE EQUITY AND DEBT INVESTMENTS IN BUSINESSES WHICH TEND TO BE MORE MATURE AND HAVE A LOWER DEGREE OF RISK. BOTH KINDS OF COMPANIES ARE DESERVING OF FINANCING AND, THUS, IT IS IMPORTANT TO HAVE BOTH KINDS OF VENTURE CAPITAL COMPANIES. VENTURE PARTNERSHIPS WILL GENERALLY NOT DO SBIC DEALS AND VICE VERSA. THUS, SBIC'S SERVE A VERY REAL NEED IN SUPPLYING CAPITAL TO AN IMPORTANT SEGMENT OF AMERICAN BUSINESS.

IN MY VIEW, THE SBIC INDUSTRY GAVE BIRTH TO THE VENTURE CAPITAL BUSINESS AS WE KNOW IT TODAY. THE SBIC EXPERIENCE GAINED IN THE 1960'S SHOWED INSTITUTIONAL INVESTORS THAT VENTURE CAPITAL WAS A GOOD INVESTMENT AND IN THE LATE 1960'S AND EARLY 1970'S VENTURE CAPITAL PARTNERSHIPS BEGAN TO APPEAR. WITH THEIR SUCCESS AND THE CHANGE IN THE CAPITAL GAINS TAX RATE IN 1978, INSTITUTIONAL MONEY BEGAN TO MOVE INTO VENTURE PARTNERSHIPS AT A RAPID PACE.

IN THE MEANTIME, THE SBIC INDUSTRY, WHILE STILL GROWING, HAS BECOME PROPORTIONATELY A MUCH SMALLER PART OF THE VENTURE CAPITAL BUSINESS. WHY? I BELIEVE THE ANSWER IS BASIC UNCERTAININITY -- UNCERTAININITY OF FUNDING, UNCERTAININITY OVER CONSISTENCY OF REGULATION, AND UNCERTAININITY OVER THE SURVIVAL OF THE SBA ITSELF.

TO BE BRUTALLY FRANK, BY FAR THE MOST IMPORTANT REASON TO BE AN SBIC IS THE ABILITY TO BORROW MONEY. THE PRICE PAID IS THE REGULATION BY THE SBA. OVER THE YEARS THERE HAS BEEN CONTINUOUS UNCERTAININITY ABOUT FUNDING. THERE HAVE BEEN LIMITATIONS ON AMOUNT AND, AT TIMES, IT SIMPLY HAS NOT BEEN AVAILABLE.

IN ADDITION, THERE HAVE BEEN CONSTANT CHANGES IN SBA REGULATIONS WHICH HAVE MADE LIFE DIFFICULT FOR SBIC MANAGERS AND HAVE, IN EFFECT, CHANGED THE RULES OF THE GAME IN THE MIDDLE OF THE CONTEST.

LASTLY, THERE HAS BEEN CONSIDERABLE UNCERTAININITY ABOUT THE SURVIVAL OF THE SBA ITSELF. DURING THE LAST FEW YEARS OF MY INVOLVEMENT WITH THE SBIC INDUSTRY, WE NEEDED TO MOUNT A CAMPAIGN EVERY TWO YEARS TO MAKE SURE THAT THE SBA DID NOT DISAPPEAR, SWEEPING THE SBIC BUSINESS WITH IT.

FOR THESE BASIC REASONS, I STRONGLY SUPPORT S 1929. I BELIEVE IT WILL GIVE THE SBIC BUSINESS THE CERTAININITY IT NEEDS TO SURVIVE AND TO GROW AGAIN. IT ALSO HAS THE POSITIVE ASPECT OF HAVING THE SBIC INDUSTRY MAKE A SIGNIFICANT INVESTMENT IN THE PROCESS SO THAT IT WILL HAVE A HIGH DEGREE OF INTEREST IN SELF GOVERNMENT, THUS LOWERING THE NEED FOR SBA INVOLVEMENT. MOST IMPORTANTLY, IT MEANS CONTINUED SUPPORT FOR THE ENTREPRENEURS WHO REALLY ARE THE MOST IMPORTANT COG IN THE WHEEL.

ON A PERSONAL NOTE, MY WIFE JANICE LEEMING AND I HAVE DISCUSSED HER STARTING AN SBIC. MY ADVICE TO HER HAS BEEN SIMPLE. IF COSBI IS PASSED, GO FOR IT. IF NOT, DON'T.

FINALLY, FOR THE BENEFIT OF THE COMMITTEE, I HAVE ATTACHED THE STATEMENTS OF TWO OTHER NVCA MEMBERS WHICH DESCRIBE THE DIFFERENCES BETWEEN SBIC FINANCINGS AND THOSE DONE BY MOST OF OUR NVCA MEMBERS.

STATEMENT OF

JOHN D. CURTIN, JR.

PRESIDENT, CURTIN & CO., INCORPORATED

HOUSTON, TEXAS

AND

MEMBER OF THE BOARD

NATIONAL VENTURE CAPITAL ASSOCIATION

SUBMITTED TO

THE

COMMITTEE ON SMALL BUSINESS

U.S. SENATE

FEBRUARY 24, 1988

I am John D. Curtin, Jr., President of Curtin & Co., Incorporated, and General Partner of Brazos Ventures, L.P., of Houston, Texas. I am also a member of the Board of Directors of the National Venture Capital Association (NVCA) which represents 226 member firms who have over 18 billion dollars under management. As a representative of the NVCA and the venture capital industry, I appreciate the opportunity to be here this morning and testify on behalf of the proposed legislation to create the Corporation for Small Business Investment (COSBI). The NVCA has always recognized the importance of the SBIC program in venture capital formation and investing in the United States and strongly supports the COSBI legislation because we believe it will provide stability and support for the SBIC program.

The NVCA members understand that a strong SBIC program supports and compliments their interests and activities, and believe that the NVCA should support the SBIC's. Both groups do venture capital investing, and there is some overlap, but not much. Both are essential to the development of new companies, new technologies, and new jobs in the United States.

During the past eighteen years, I have personally been directly engaged in financing venture capital companies in the Southwest. These have ranged from very early seed-money to late stage buy-out deals, they have been high technology, low technology, and no technology. Frequently, we have been in investments with other private venture capital limited partnerships---NVCA firms. Sometimes we have been in investments with SBIC's,---small local ones, regional SBIC's, and large "national" SBIC's.

The investment behavior of the private venture capital partnerships--the most typical (i.e., 81% of the members in 1986) NVCA members--differs from the typical SBIC's in several ways. There may be several reasons for the differences, but I believe they can be attributed to the sources of the funds invested, and, thus, to the investment objectives for the money.

To describe the typical venture capital fund:

It is a limited partnership with a ten year life.

The funds are committed as "equity", there is no fixed obligation to pay interest, or a return, or make distributions.

The limited partners are pension funds, as to 55% of the funds invested in 1986, foreign investors (12%), insurance companies (10%), individuals and families (8%), corporations (8%), and endowments and foundations (7%). They are investing a small part--probably less than 2 or 3%--of their total funds in venture capital in the expectation of above average returns, that is, twenty-five to thirty percent or more, over time.

The limited partners provide patient money under a long-term commitment, grant the general partners the management autonomy of the limited partnership form, and offer a strong personal incentive---generally a 20% share of profits---to engage the managers to invest the funds.

With this kind of vehicle for investing the general partners do what you might expect: they seek to develop significantly above average returns. Their investment behavior looks like this:

> They look for major investment growth opportunities and often actively eschew venture capital investments which offer good, or even somewhat above average, returns. They will take some very high risk deals believing that their "home runs" will more than cover their losses.

As a result, their investments tend to be concentrated in high-technology or high-growth industries. In 1986, for example, communications, computers and electronics took up 59% of all the funds invested by NVCA firms, genetic engineering and other medical/health related deals took another 16%. Only 25% of their money was directed to all other business opportunities.

Not surprisingly, we find a geographic concentration of NVCA funds. They go where the action is--to Silicon Valley, Route 128, etc.

Without the constraints of debt or interest payments, this money can more readily flow anywhere there is a perceived high return: into seed money, early-stage companies or even into buy-outs. Even though SBIC's invest more, as a percentage of their funds invested, in young companies, NVCA members invest more total money in early stage companies, and, I believe, much more in high risk start-ups.

With such a singular motivation for exceptional returns the venture funds also tend to be more concentrated in their investments. They put more of their money in fewer investments, with good and bad results. They have no limitations, except self-imposed ones, prohibiting concentration of investments. They can, and will, more readily fund struggling ventures time and again, hoping for ultimate success. They can back the winners, and knowing that big winners are hard to find, will take the opportunities to compound success.

In contrast, the SBIC's seem more reasonable, ordered and rational. Also, more conservative. Their managements, for the most part, do not have strong personal incentives to hit home-runs, but every good reason to hit singles regularly. They are constrained by their leverage and must make sure their investments provide enough yield to fund their money costs. They cannot invest more than twenty percent of their stated capital in any one company, regardless of need or opportunity, without getting waivers. They cannot force an early return of funds, even in the unusual case that justifies it.

The SBIC's are owned, managed, and funded in a different way. In their case, the "equity" money is the actual ownership and control of the SBIC. Normally, the "equity" is the direct employer of the managers. It normally determines the investment policy; and often controls the investment decision. The motivations behind the money invested in SBIC's are more varied, and not in any case as singularly focussed on simply getting high rates of return. For example, many SBIC's are affiliated with banks or S & L's, and are created to assist business development in a specific trade area. Many have a community economic development motivation; sometimes it is quite specific and explicit.

The equity funds are usually highly leveraged through the SBIC program. The leverage is, of course, the key to funding the program, but it does color the investment process. The SBIC investment managers must be sure they invest at enough yield to cover their costs of funds and operating expenses. This severely limits the percentage of their funds which they can put into developing companies which have no prospects for generating cash flow in the near future. On the other side, it stimulates their financing of good businesses which have cash flow and solid but maybe unexciting prospects.

The SBIC's cannot fund secondary transactions and cannot control a company. They are restricted to investing in "small businesses", as defined. Thus, they are generally prohibited from many buy-out transactions. Venture capital partnerships have no such limitations.

The SBIC's are limited as to concentration of their investments. One, I believe, intended result of this limitation is a larger spread and greater diversification of investment risks. One indirect result is, perhaps, more of a "portfolio" mentality in managing the investments.

The SBIC's have a longer life, or at least a less well-defined termination and payout. This creates different ways of thinking about the investment process, and the kinds of deals done. It creates more continuity, more institutionalization of the process.

The structural differences between these two forms of venture capital investing suggest that because the private venture capital partnerships do not, normally, use financial leverage, i.e., borrow money, they are forced to leverage their efforts and limit their scope in the hope of finding returns adequate to the risks of investing in new and small businesses.

The SBIC's, on the other hand, because of the leverage available through the program, can more reasonably invest across a broader range of the risk/reward spectrum. Because of the leverage, SBIC's can be formed and managed with a smaller amount of equity funding. This permits and promotes wide geographic and industry coverage. It enables the SBIC's to invest in a wide variety of businesses across the country, businesses which otherwise might not find venture capital.

I hope you can see why the SBIC program provides financing for the growth of America which is not being, and cannot be, provided in any other way.

Thank you.

STATEMENT OF

RICHARD M. BURNES, JR.

PARTNER, CHARLES RIVER VENTURES

BOSTON, MASSACHUSETTS

AND

MEMBER OF THE BOARD

NATIONAL VENTURE CAPITAL ASSOCIATION

SUBMITTED TO

THE

COMMITTEE ON SMALL BUSINESS

U.S. SENATE

FEBRUARY 24, 1988

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

GOOD MORNING! MR. CHAIRMAN, IT IS A PLEASURE TO HAVE THE OPPORTUNITY TO APPEAR IN FRONT OF YOUR COMMITTEE THIS MORNING IN AN EFFORT TO HELP THE CAUSE OF SMALL BUSINESS FINANCING. EARLY IN THE NINETEENTH CENTURY THE FRENCH HISTORIAN DE TOCQUEVILLE POINTED OUT THAT INDIVIDUALISM AND

ENTREPRENEURIAL SPIRIT WERE KEY INGREDIENTS IN THE CHARACTER OF THE PEOPLE OF THE UNITED STATES. HE SAW THAT THIS LED US TO BEING A LAND OF SMALL COMMERCIAL ENTERPRISES. WHAT WAS TRUE THEN IS STILL TRUE TODAY, AND THE COSBI BILL, WHICH YOU ARE CONSIDERING, IS A METHOD OF CONTINUING TO ENCOURAGE THE DEVELOPMENT OF THAT ESSENTIAL ENTREPRENEURIAL SPIRIT.

I AM RICHARD BURNES, A GENERAL PARTNER AT CHARLES RIVER VENTURES IN BOSTON, MASSACHUSETTS. THREE OF US ESTABLISHED THE FIRM IN 1970 AND, SINCE THEN, HAVE MADE INVESTMENTS IN 120 COMPANIES, TOTALING OVER $100 MILLION. WE RAISED THE CAPITAL, PRIMARILY FROM INSTITUTIONAL SOURCES IN FIVE SEPARATE PARTNERSHIPS, WITH TOTAL CAPITAL OF APPROXIMATELY $150 MILLION. OUR INVESTMENT PHILOSOPHY IS TO TRY AND IDENTIFY AND INVEST IN EMERGING GROWTH BUSINESSES. WE ARE SEEKING THE LARGE BUSINESSES OF THE 1990s. MOST OF THEM ARE TECHNOLOGICALLY-BASED. OUR AVERAGE INITIAL INVESTMENT IS JUST OVER $1.0 MILLION.

PRIOR TO CHARLES RIVER I SPENT SIX YEARS AS A VICE PRESIDENT OF FEDERAL STREET CAPITAL CORPORATION, A BANK-OWNED SBIC IN BOSTON.

WE ARE ORGANIZED AS A PRIVATE VENTURE CAPITAL PARTNERSHIP AND CURRENTLY DO NOT OPERATE AN SBIC. IN OUR FIRST PARTNERSHIP WE DID NOT USE THE SBIC FORMAT BECAUSE, AT THE TIME, THERE WAS NO FUNDING AVAILABLE FOR LEVERAGE. HOWEVER, IN 1976, WHEN WE SET UP OUR SECOND PARTNERSHIP, THE FUNDING FROM CONGRESS WAS AVAILABLE, AND WE DID HAVE AN SBIC, OF WHICH I WAS PRESIDENT. WE WERE PART OF THE PROGRAM FROM 1976 UNTIL 1981, WHEN WE TURNED IN OUR LICENSE BECAUSE OF THE INSTABILITY OF THE FUNDING AND THE INHERENT LIMITATIONS OF THE SBIC CORPORATE REGULATIONS.

I AM CURRENTLY ON THE BOARD OF DIRECTORS OF THE NATIONAL VENTURE CAPITAL ASSOCIATION AND AM HEAD OF THEIR RESEARCH COMMITTEE. THIS MORNING, RATHER THAN FOCUSING ON THE PROBLEMS THAT THE COSBI BILL WILL SOLVE, I AM GOING

TO TALK FOR A FEW MINUTES ABOUT HOW WE, AS PRIVATE VENTURE CAPITALISTS, ARE DIFFERENT FROM THE SBICs AND HOW WE CAN BOTH WORK TOGETHER TO SUPPORT SMALL BUSINESSES.

THE PRIMARY DIFFERENCE BETWEEN THE TWO STRUCTURES IS THAT PRIVATE VENTURE CAPITALISTS USE PURE EQUITY TO MAKE INVESTMENTS WHILE THE SBICs INVEST A COMBINATION OF DEBT AND EQUITY. THE RESULT IS THAT WE GENERALLY MAKE INVESTMENTS WITH VERY DIFFERENT RISK CHARACTERS. THE PRIVATE VENTURE CAPITALISTS TYPICALLY TAKE LONG-TERM, HIGH RISKS WITH THE EXPECTATION OF SIMILARLY HIGH REWARDS. THIS MAY MEAN FUNDING, RESEARCH AND DEVELOPMENT IN, FOR INSTANCE, BIOTECHNOLOGY COMPANIES, WHERE THE OUTCOME IS FAR FROM CERTAIN. THE SBICs, BECAUSE THEY ARE UTILIZING DEBT, USUALLY HAVE A CLEARER VIEW OF HOW THEIR CAPITAL IS GOING TO BE RETURNED SO THAT THEY CAN REPAY THE DEBT. THE RISK PROFILE OF AN SBIC PORTFOLIO IS GENERALLY SUBSTANTIALLY LOWER.

THE USE OF LEVERAGE ALSO MEANS THAT THE SBIC CAN INVEST IN BUSINESSES WITH SLOWER GROWTH AND STILL EARN AN ACCEPTABLE RETURN ON THEIR INVESTMENT. TO USE A BASEBALL ANALOGY, AS PRIVATE VENTURE CAPITALISTS, WE STAND AT THE PLATETTRYING TO HIT TRIPLES AND HOME RUNS, WHILE THE SBICs CAN HIT SINGLES AND STILL HAVE A VIABLE BUSINESS BECAUSE OF THE LEVERAGE. THE COUNTRY NEEDS MORE OF BOTH KINDS OF CAPITAL.

THE SECOND CRITICAL DIFFERENCE BETWEEN PRIVATE VENTURE CAPITAL AND SBICs IS THE SIZE OF THE FINANCINGS. WE PRIVATE VENTURE CAPITALISTS TYPICALLY ARE SEEKING TO PLACE ONE, TWO OR THREE MILLION DOLLARS IN A VENTURE IN HOPES THAT IT WILL BECOME ONE OF THE FORTUNE 500 WITHIN A PERIOD OF YEARS. MANY OF THE SBICs ARE FOCUSED ON THE BUSINESSES THAT ARE GOING TO REMAIN MODEST IN SIZE BUT NEED CAPITAL TO CONTINUE TO GROW. STATISTICS FROM THE SMALL BUSINESS ADMINISTRATION SHOW THAT THE AVERAGE SBIC FINANCING IS ONLY $269 K, WHILE THE VENTURE CAPITALIST'S AVERAGE

INVESTMENT IS WELL OVER $1.0 MILLION. MOST PRIVATE VENTURE CAPITALISTS ARE NOT STAFFED TO MAKE SMALLER INVESTMENTS. AT CHARLES RIVER, UNLESS WE CAN PUT $750 K - $1.0 MILLION TO WORK, WE ARE NOT INTERESTED.

THE THIRD DIFFERENCE I WOULD LIKE TO EMPHASIZE IS THE RELATIVE GEOGRAPHIC CONCENTRATION OF PRIVATE VENTURE CAPITAL INVESTMENTS VS. THE SBICs. VENTURE ECONOMICS, IN WELLESLEY, MASSACHUSETTS, THE STATISTICIANS FOR THE VENTURE CAPITAL INDUSTRY, HAS RECENTLY SHOWN THAT THERE HAS BEEN A CONTINUED CONCENTRATION OF PRIVATE VENTURE CAPITAL IN THE TRADITIONAL CENTERS SUCH AS THE RT. 128 AREA IN BOSTON AND SILICON VALLEY IN NORTHERN CALIFORNIA. THE REASON FOR THIS IS THAT THE HIGH TECH VENTURES WE BACK REQUIRE A STRONG, SPECIALIZED INFRASTRUCTURE TO SUPPORT THEIR GROWTH. SPECIALIZED SUPPLIERS OF SERVICES, MATERIAL, EQUIPMENT AND LABOR HAVE THRIVED IN THESE AREAS, MAKING IT EASIER FOR THE HIGH TECH COMPANIES TO EMERGE AND GROW. ALSO, THESE BUSINESSES TEND TO GROW OUT OF ONE ANOTHER IN SPIN-OFFS.

THERE HAVE BEEN MASSIVE EFFORTS TO START THE PROCESS IN OTHER PARTS OF THE COUNTRY, BUT THEY HAVE ONLY ACHIEVED MODEST SUCCESS. THE PROBLEM IS THAT THE SPECIALIZED INFRASTRUCTURE DOES NOT EXIST AND IS HARD TO START. THE COMPANIES THAT MOST SBICs ARE FOCUSED ON ARE MORE TRADITIONAL BUSINESSES. THEY TYPICALLY DO NOT REQUIRE THE SAME SORT OF SUPPORT SYSTEM AND THUS ARE LOCATED THROUGHOUT THE COUNTRY. THERE ARE MANY SOUND BUSINESSES THAT REQUIRE GROWTH CAPITAL THAT WE PRIVATE VENTURE CAPITALISTS NEVER SEE THAT ARE BEING SERVICED BY SBICs. IN THIS SENSE THEY ARE PROVIDING A VALUABLE SERVICE TO THE COUNTRY AND DESERVE YOUR SUPPORT.

FOR A VARIETY OF REASONS, THERE ARE USUALLY TWO OR MORE VENTURE FIRMS FINANCING A COMPANY. IT IS SIGNIFICANT TO NOTE THAT WE SELDOM RUN ACROSS SBICs AS PARTICIPANTS IN OUR FINANCINGS. I EXPECT IT IS BECAUSE OF THE THREE REASONS I HAVE OUTLINED ABOVE.

BEFORE CLOSING I WOULD LIKE TO COMMENT BRIEFLY ON ONE OF THE FUNDAMENTAL DRIVERS BEHIND THE AMERICAN ECONOMY, ENTREPRENEURIAL SPIRIT. FOR THE PAST SEVERAL DECADES WE, AS A NATION, HAVE TRIED TO COMPETE WITH THE JAPANESE. THERE HAVE BEEN VOICES THAT SAY WE SHOULD TRY TO DUPLICATE THEIR CONCENTRATION OF BUSINESS ACTIVITY, THAT WE SHOULD FOCUS MORE ON LARGE BUSINESSES, AND THAT OUR SMALL BUSINESSES SIMPLY CANNOT COMPETE. TO A DEGREE THEY ARE RIGHT. CERTAIN INDUSTRIES WILL BE DOMINATED BY THE LARGE FIRMS. HOWEVER, SMALL BUSINESSES ARE THE UNQUESTIONED LEADER IN JOB CREATION, PRODUCT INNOVATION, AND DEVELOPMENT OF NEW TECHNOLOGIES IN THIS COUNTRY. LARGE COMPANIES HAVE NOT DONE THE JOB FOR US. THE ENTREPRENEURIAL SPIRIT IS WHAT OUR ECONOMY IS BUILT ON. WE ARE A HETEROGENOUS NATION OF STRONG INDIVIDUALS. TRYING TO FIT OUR PEOPLE INTO THE JAPANESE MOLD WILL NOT WORK. OUR STRENGTH IS IN SMALL BUSINESS, AND WE MUST RELY ON IT IN THE FUTURE, AND THE PASSAGE OF THE COSBI LEGISLATION IS A KEY COMPONENT IN BUILDING ON OUR INHERENT STRENGTHS.

The CHAIRMAN. Thank you, Mr. Little.

Let me say that you are really preaching to the saved. First of all, I appreciate everything you said. Of course, it is a truism. Politicians say it for whatever political gain they can get out of it. We all cherish small business. And I come from a state that is virtually nothing but small business. And so, it is politically to my benefit to not only chair this committee, but show the flag on small business at every opportunity.

But as a former small businessman, what I would not have given—because back when I was in business, there was just one bank, and it never occurred to me that there was another bank 20 miles down the road. And I might also say there was very little competition in banking back in those days. And there were requirements. You know, they would give you anything you want as long as you were willing to deposit your wife and children with them and any other assets you happened to have.

But what I wouldn't have given back then to have been able to go to an SBIC with a couple of ideas I had for expanding my own business and so on. As I look back on it—I am not sure I was that visionary at the time, as I look back on it, I know if I had any sense at all and could have gotten the capital, I could have tripled my profits, quadrupled my profits. But it just wasn't available to me. Money was a lot tighter then. Banks were much, much more conservative. They didn't like ideas. They wanted assets for collateral.

I never started making any money, frankly, until I found a banker who was a very modernistic type guy who wanted to know what I was going to do with the money, and as my grandfather used to say, there is more in the man than there is in the land. And I was never as shocked in my life as I was when he gave me $20,000 on my signature. I just had never heard of such a thing. And that is when I first began to make money.

But getting back to the point, your point is such a cogent one about certainty and stability. And if there is anything that is absolutely certain, it is that the political process guarantees uncertainty. That's just the way it is.

But I do think COSBI could go a long way toward eliminating the uncertainty as has happened in some other areas where we have sort of cut corporations loose with a minimum of regulation. As operators of COSBI, we will expect you to be honest and occasionally we are going to check to make sure you are being honest with us. But we do not want to micromanage this operation.

I might add that it is not just us politicians who contribute so much to the uncertainty. It is not just here. It's the whole business community. When we reform the tax code every other year and corporations are trying to do planning for 10, 15 years in advance, it's a real travesty. And nobody appreciates that better than I do.

Some day maybe Government will become bipartisan enough to put professionals in these jobs—Cabinet level officers, and the head of the Congressional Budget Office, and the head of OMB—and pay them enough so that the private sector doesn't look all that attractive. You and I both know that once you have been a Senator, you can go out and make more money than you can in the U.S. Senate. But if you have been a Cabinet officer or if you have run SBA or some of these agencies around reasonably successfully, you can make so much more money.

But all I am saying is you have somebody like Alice Rivlin over at CBO who is very good, and you have somebody like Rudolph Pender who is very good, but number one, those people are subject to a lot of abuse. Politicians—one of their favorite pastimes is abusing people in the bureaucracy. But if we had some professionalism at SBA, for example, and you put an administrator in there, and the next President recognized his talents because he was doing an excellent job and would leave him there, that would do an awful lot to at least improve stability and certainty in the marketplace. I don't know whether we will ever get to that point or not.

When I was first elected Governor, we had a fairly good civil service type program that Governor Rockefeller, my predecessor had pretty much put in and they told me, for example, that on January 1, when the new Governor took over, everybody in the revenue department picked up his satchel and moved out, and all of the new people who had been promised jobs moved in.

But I tried to pick good people who were professionals, and I might say that I kept three or four of Governor Rockefeller's appointees. And you can imagine what my party was saying to me about that. You can imagine how they appreciated that. That was a job that they felt ought to be a political plum. I'm just not that partisan because, as I say, particularly in the small business area, I know what certitude is compared to uncertainties and instability.

So, I really appreciate your testimony. You tell your wife I'm going to try to help her make an investment. [Laughter.]

And I hope it will be profitable. Your testimony is very sensible, very common-sensical, and very telling. And I thank you very much for the time you took to prepare it and to be with us. And that goes for all the witnesses who appeared here today. Thank you all very much.

We'll stand in recess until the call of the Chair.

[Whereupon, at 4:13 p.m., the Committee recessed subject to the call of the Chair.]

S. 1929, A BILL TO CREATE THE CORPORATION FOR SMALL BUSINESS INVESTMENT (COSBI)

THURSDAY, MARCH 31, 1988

U.S. Senate,
Committee on Small Business,
Washington, DC.

The Committee met, pursuant to notice, at 9:30 a.m., in room SR 428A, Russell Senate Office Building, Hon. Lowell Weicker, Jr. (Acting Chairman) presiding.

STATEMENT OF HON. LOWELL WEICKER, JR., A U.S. SENATOR FROM THE STATE OF CONNECTICUT

Senator **Weicker**. The Committee will come to order. Today we have before us S. 1929, a bill to create the Corporation for Small Business Investment, (COSBI), and the Committee will hold its second hearing on this legislation, a bill that Chairman Bumpers and I introduced to establish COSBI, to operate and to fund the Small Business Investment Companies and Minority Enterprise Small Business Investment Company Programs.

I want to commend Chairman Bumpers for authorizing this second day of hearings. I share with him a commitment to move this legislation with or without the Administration. At stake is whether billions of dollars of capital will flow to the small business sector over the next decade, and the number of jobs created and the economic activity generated by COSBI dictates that we move on this proposal.

I ask unanimous consent that the remainder of my statement be included in the record at this point.

[The prepared statement of Senator Weicker follows:]

OPENING STATEMENT OF SENATOR LOWELL WEICKER, JR.
HEARING ON S. 1929, A BILL TO CREATE THE CORPORATION FOR SMALL BUSINESS INVESTMENT (COSBI)

MARCH 31, 1988

TODAY, THE COMMITTEE WILL HOLD ITS SECOND HEARING ON S. 1929, A BILL THAT CHAIRMAN BUMPERS AND I INTRODUCED TO ESTABLISH THE CORPORATION FOR SMALL BUSINESS INVESTMENT (COSBI) TO OPERATE AND TO FUND THE SMALL BUSINESS INVESTMENT COMPANY (SBIC) AND MINORITY ENTERPRISE SMALL BUSINESS INVESTMENT COMPANY (MESBIC) PROGRAMS. I WANT TO COMMEND CHAIRMAN BUMPERS FOR AUTHORIZING THIS SECOND DAY OF HEARINGS. I SHARE WITH HIM A COMMITMENT TO MOVE THIS LEGISLATION, WITH OR WITHOUT THE ADMINISTRATION. AT STAKE, IS WHETHER BILLIONS OF DOLLARS OF CAPITAL WILL FLOW TO THE SMALL BUSINESS SECTOR OVER THE NEXT DECADE. THE NUMBER OF JOBS CREATED AND THE ECONOMIC ACTIVITY GENERATED BY COSBI DICTATES THAT WE MOVE ON THIS PROPOSAL.

LET US BE CLEAR. THE CONGRESS AND THIS COMMITTEE BELIEVE THAT THE SBIC AND MESBIC PROGRAMS ARE NECESSARY. THEY FILL REAL NEEDS OF THE NATION'S SMALL BUSINESS COMMUNITY FOR REASONABLY PRICED VENTURE CAPITAL. THEY PROVIDE ASSISTANCE WHICH IS NOT AVAILABLE OTHERWISE. IN OTHER WORDS, WE REJECT THE ADMINISTRATION'S PHILOSOPHICAL CONTENTION THAT THERE IS NO NEED FOR THESE

PROGRAMS BECAUSE THERE IS A SUFFICIENT SOURCE OF VENTURE CAPITAL FOR SMALL BUSINESSES. THEREFORE, IT IS NOT CONSTRUCTIVE FOR THE ADMINISTRATION TO SIMPLY OPPOSE THIS PROPOSAL.

OUR WITNESSES TODAY INCLUDE JIM ABDNOR, ADMINISTRATOR OF THE SMALL BUSINESS ADMINISTRATION AND CHARLES SETHNESS, ASSISTANT SECRETARY FOR DOMESTIC FINANCE AT THE TREASURY DEPARTMENT, WHO WILL PRESENT US WITH THE ADMINISTRATION'S TESTIMONY IN OPPOSITION TO THE CONCEPT OF COSBI. THEN WE WILL HEAR FROM REPRESENTATIVES OF THE SBIC/ MESBIC INDUSTRIES: MR. DONALD GREENE, OF NAIC AND MR. DAVID JONES, OF NASBIC. FINALLY, WE WILL HEAR FROM MR. TOM STANTON AND MR. JIM MURRAY, ATTORNEYS WHO ARE KNOWLEDGEABLE ABOUT GOVERNMENT SPONSORED ENTERPRISES.

Senator **Weicker**. Do you have an opening statement, Senator Pressler, who has joined us here?

STATEMENT OF HON. LARRY PRESSLER, A U.S. SENATOR FROM THE STATE OF SOUTH DAKOTA

Senator **Pressler**. I have a brief opening statement that I will submit for the record. I thank you very much.

[The prepared statement of Senator Pressler follows:]

STATEMENT OF SENATOR LARRY PRESSLER
BEFORE THE
SENATE COMMITTEE ON SMALL BUSINESS
HEARING ON S. 1929
MARCH 31, 1988

Thank you Mr. Chairman.

S. 1929, which would create a Government-sponsored private Corporation for Small Business Investment (COSBI), is a most important legislative proposal. The concept of providing a secondary market for loans to and investment in Small Business Investment Companies and establishing a special funded trust for small business investment companies (MESBIC) clearly has merit and deserves close study.

The purposes of S. 1929 seem to be a logical extension of the privatization that we take for granted in the day-to-day activities of Fannie Mae, Freddie Mac and Ginnie Mae. The Administration also favors the privatization of the SBIC and MESBIC programs. However, the Administration expresses strong opposition to the way it would be achieved in the enactment of the legislation we have before us today.

Some of the concerns that I feel need to be addressed are:

> Whether the Government's contribution to COSBI and the trust is adequate but reasonably limited;
>
> Whether the Government has sufficient voice and control in the operations of COSBI and the trust;
>
> Whether the interests of small business will be best served by this legislation; and,
>
> Whether there is adequate protection for the Nation's taxpayers.

Mr. Chairman, I hope that today's hearing will shed light on these and the other provisions contained in this legislation.

Senator **Weicker**. I notice Senator D'Amato has just entered the room. Do you have an opening statement, Senator D'Amato?

STATEMENT OF HON. ALFONSE M. D'AMATO, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator **D'Amato**. Mr. Chairman, I do have a statement, it is rather voluminous, and so as a result of that, and I know that you want me to put it all into the record. I would ask permission that it be included in the record as if read in its entirety.

Senator **Pressler**. Mr. Chairman, let me just——

Senator **Weicker**. There seems to be an objection. [Laughter.]

Senator Pressler has never heard one of your statements.

Senator **Pressler**. Mr. Chairman, let me also explain that at 10 o'clock I leave. I have a bill in the Commerce Committee on Hearing Aid Compatibility on Telephones. It is my bill. I called for the hearings, so I will have to be there, so I have to leave here in about 10 or 15 minutes, no offense to anybody.

Senator **Weicker**. Senator Pressler, we always enjoy having you here and realize you do have other duties elsewhere in the Capitol. Senator D'Amato's statement will be included in the record in its entirety at this time.

[The prepared statements of Senators D'Amato and Dixon follow:]

STATEMENT BY SENATOR ALFONSE M. D'AMATO
BEFORE THE SMALL BUSINESS COMMITTEE
CORPORATION FOR SMALL BUSINESS INVESTMENT CHARTER ACT
MARCH 31, 1988

MR. CHAIRMAN, I WOULD LIKE TO WELCOME TO THE SMALL BUSINESS COMMITTEE THIS MORNING OUR DISTINGUISHED PANEL OF WITNESSES WHO WILL CONTINUE THE DISCUSSION ON LEGISLATION WHICH WOULD CREATE THE CORPORATION FOR SMALL BUSINESS INVESTMENT (COSBI).

I WOULD LIKE TO REITERATE MY SUPPORT FOR THIS LEGISLATION. SMALL BUSINESSES ARE THE BACKBONE OF OUR NATION PROVIDING SERVICES THAT HAVE MADE THE U.S. THE MAJOR PLAYER THAT IT IS IN THE INTERNATIONAL MARKETS.

SMALL BUSINESSES FACE DIFFERENT TYPES OF PROBLEMS THAN DO THEIR LARGER COUNTERPARTS. FOR INSTANCE, IT IS NECESSARY THAT SMALL BUSINESSES HAVE REASONABLE ACCESS TO THE DEBT MARKET OR TO CAPITAL. SOME BUSINESSES ARE HAVING DIFFICULTY IN OBTAINING THE NECESSARY FINANCING NEEDED TO HELP THEM CONTINUE TO GROW AND REMAIN COMPETITIVE. THE CREATION OF A CORPORATION FOR SMALL BUSINESS INVESTMENT PROVIDES THESE

BUSINESSES WITH THE FININACIAL BACKING NEEDED IN TODAY'S MARKET.

THE ADMINISTRATION HAS CONTINUED TO OPPOSE COSBI LEGISLATION EVEN THOUGH S. 1929 ADDRESSES MOST OF THE CONCERNS EXPRESSED BY THE TREASURY IN A LETTER TO SENATOR WEICKER IN 1986. S. 1929 ESTABLISHES A DEBT TO EQUITY RATIO LIMIT (15:1) ON COSBI DEBT ISSUANCES; IT GIVES SBA REGULATORY POWER AND OVERSIGHT AUTHORITY OVER COSBI AND SBIC'S; AND IT GIVES TREASURY APPROVAL AUTHORITY OVER THE ISSUANCE OF COSBI DEBT.

I LOOK FORWARD TO THE TESTIMONY OF OUR WITNESSES AND TO THE INSIGHT THEY ARE SURE TO PROVIDE THIS COMMITTEE ON THE COSBI LEGISLATION.

THANK YOU, MR. CHAIRMAN.

MARCH 31, 1988

STATEMENT BY SENATOR ALAN J. DIXON

COMMITTEE ON SMALL BUSINESS HEARING ON THE CORPORATION FOR SMALL BUSINESS INVESTMENT CHARTER ACT

S. 1929

THANK YOU, MR. CHAIRMAN FOR HOLDING THIS HEARING TODAY.

THE CORPORATION FOR SMALL BUSINESS INVESTMENT IS A REAL, WORKABLE ALTERNATIVE TO DIRECT GOVERNMENT INTERVENTION IN AN INDUSTRY WHICH NO LONGER NEEDS IT. COSBI WILL PROVIDE FUNDS TO THE TREASURY, BUT MORE IMPORTANTLY IT WILL ELIMINATE THE ONGOING NEED TO ALLOCATE SCARCE FEDERAL DOLLARS TO SMALL BUSINESS INVESTMENT COMPANIES.

SBIC'S, AND THEIR SPECIALIZED COUSINS THE MESBIC'S, PROVIDE ESSENTIAL FUNDING TO SMALL DISADVANTAGED COMPANIES. MAKE NO MISTAKE THAT THE FIRMS HELPED BY SBIC'S ARE FINANCIALLY DISADVANTAGED. THESE SMALL FIRMS DO NOT HAVE THE SAME ACCESS TO CAPITAL AS LARGER, MORE ESTABLISHED COMPANIES. CLEARLY THEY MUST VIGOROUSLY PURSUE EVERY SOURCE OF FUNDS AVAILABLE TO THEM. EVEN SO, THEIR SUCCESS IN ACQUIRING NEEDED CAPITAL IS FREQUENTLY MARGINAL. FAMILIES AND FRIENDS ARE TAPPED FOR SEED MONEY BUT IT IS USUALLY NOT ENOUGH. THE COMPANIES THEN TURN TO THEIR LOCAL BANKS FOR LOANS. NATURALLY THE BANKS ARE RELUCTANT TO APPROVE THE LOANS WITHOUT HARD ASSETS TO USE AS COLLATERAL OR UNLESS SOME OTHER ENTITY TAKES THE FIRST STEP. THIS IS WHERE SBIC'S COME IN.

SBIC'S PROVIDE LOANS OR EQUITY INFUSIONS WHICH ACCOMPLISH TWO IMPORTANT THINGS. FIRST, URGENTLY NEEDED FUNDS ARE OBTAINED AT MANAGEABLE RATES. SECOND, AND JUST AS IMPORTANT, THEY INCREASE THE OPERATING BASE WHICH BANKS USE TO GAUGE THE RISK OF ADDITIONAL LOANS. BECAUSE SBIC LOANS ARE SUBORDINATED TO OTHER DEBT, BANKS BECOME MORE COMFORTABLE WITH THE PROSPECTS OF REPAYMENT AND ARE THEREBY INCLINED TO APPROVE SUBSEQUENT LOAN APPLICATIONS.

CONSIDERING THE IMPORTANCE OF MAINTAINING HEALTHY AND PRODUCTIVE SBIC'S AND MESBIC'S I CANNOT UNDERSTAND THE ADMINISTRATION'S CONTINUED RELUCTANCE TO COSBI. THE TWO PRIMARY AREAS OF CONCERN TO THE ADMINISTRATION ARE THE ASSET SALE OF SBIC DEBENTURES AND THE FINANCIAL BACKSTOP FOR COSBI

DEBT. TO THAT I WOULD POINT OUT THAT THE SBA'S RECENT BUDGET PROPOSAL WAS FILLED WITH LOAN PORTFOLIO SALES AND THE $500 MILLION BACKSTOP PROVISION MUST PASS THROUGH MANY GATES BEFORE IT IS RELEASED.

WE OWE IT TO THE SBIC INDUSTRY TO RESOLVE THE DOUBT SURROUNDING ITS ABILITY TO SECURE FUNDS. ANYONE FAMILIAR WITH THE WORKINGS OF WALL STREET KNOWS THAT THE ONE THING FINANCIAL MARKETS CANNOT TOLERATE IS UNCERTAINTY.

I LOOK FORWARD TO HEARING FROM MY GOOD FRIEND AND FORMER COLLEAGUE SENATOR ABDNOR. I AM SURE HE REALIZES THAT SBIC'S AND MESBIC'S SERVE AN IMPORTANT ROLE IN THE ECONOMICS OF SMALL BUSINESSES. WE NEED TO CONTINUE TO SUPPORT THEM AND I BELIEVE THAT THIS INNOVATIVE CONCEPT WILL DO JUST THAT.

Senator Weicker. Our first witnesses are the Honorable James Abdnor, the Administrator of the Small Business Administration, and Mr. Charles Sethness, Associate Secretary of Domestic Affairs, Department of the Treasury. I understand both of these gentlemen are appearing in opposition to the bill. Each one of you have 1 minute to present your views. [Laughter.]

STATEMENT OF HON. JAMES ABDNOR, ADMINISTRATOR, U.S. SMALL BUSINESS ADMINSTRATION, WASHINGTON, DC, ACCOMPANIED BY EDWIN T. HOLLOWAY, ASSOCIATE ADMINISTRATOR FOR FINANCE AND INVESTMENT, AND ROBERT LINEBERRY, DEPUTY ASSOCIATE ADMINISTRATOR FOR INVESTMENT

Mr. Abdnor. Mr. Chairman, I talk awfully fast, but they have trouble understanding me when I go slow. Senator Weicker, Members of the Committee, it is good to be here with you all again. I don't know about this particular issue, but it is great to see you all. We are here to testify on S. 1929, called the Corporation for Small Business Investment Charter Act, and with me today is Edwin P. Holloway who is my Associate Administrator for Finance and Investment and also I have with me Robert Lineberry, who is the Deputy Associate Administrator for Investment.

Prior to my appointment as Administrator——

Senator Weicker. If I may just at the outset state that all statements will be included in their entirety in the record. I think it is a due desire on the part of the panel to go back and forth with Q and A format much more so than written statement.

Mr. Abdnor. Thank you, Mr. Chairman, for that remark. I do have an abbreviated statement in hand and I would ask unanimous consent that my entire statement be made a part of the record.

I would like to note for the record that this testimony is in no way critical of the SBIC and the MESBIC industries, but rather demonstrates their considerable expansion during the past 7 years. For example, SBIC's increased their financing of small business concerns from $333 million in 1981 to a current annual rate of $538 million, which is an increase of 62 percent, since 1981. So there has been growth. MESBICs did even better in relative terms by increasing their financing of small concerns by 165 percent, from $54 million in 1981 to a current rate of $143 million.

Each group has increased its total capital available by both private capital additions and use of leverage from SBA. It is our opinion that the SBIC and the MESBIC Program's should be transferred to the private sector, and that continued, deep Federal financial support is no longer justified. Based upon testimony provided by the proponents of S. 1929 and statements by yourself and other Members of the Committee, there is general agreement that these programs can and should be privatized.

SBA must oppose S. 1929 because we believe it does not accomplish the transfer of these programs to the private sector. In our opinion this bill merely changes the format of the administration of these programs. It leaves the Federal Government more deeply involved in the financial risk on both an immediate and a contingent basis and, at the same time, changes the regulatory control of the program from direct Government regulation to self-regulation.

Similar schemes in agriculture and the housing sector have failed, requiring substantial bailout by the taxpayers. And listen now, this is a big difference between those institutions and what is being proposed here. The big difference in those cases is that at least they have the underlying collateral security of mortgages on homes and farms. You don't have anything like that here.

I would like to direct your attention to the charts, if I can, that I have brought with me today. If you will just take a second to look at it, I think there is quite a story here. The first of these, Financial Risk Sharing, shows that altogether COSBI will benefit from about $1.8 billion of direct and indirect support composed of a cash grant of $150 million. That's cash, and a gift of $290 million face amount of MESBIC debentures and preferred stock for a MESBIC trust, $200 million of right up front-end in capital from the Government and a $500 million backup line of credit from the Treasury. In addition, substantially all of its initial assets of about $700 million of the SBIC debentures would be fully guaranteed by the SBA.

Now, this chart also shows that the taxpayers risk in COSBI is almost 74 times that of the SBICs. Take a look at that. It is not a bad deal, 74 to 1.

The top of the next chart, Financial Investment, the one we are showing you now, shows that the SBA would provide 89 percent of COSBI's equity capital while the exhibit labeled "Control" shows the Government having one-third control at best. In truth, the board seats allocated SBA's Administrator and four other Presidential appointees, to me seems to be more a window dressing since these directors could, on any issue, easily be outvoted by the SBIC industry inside directors. You catch all of the responsibilities as administrator up there but you really wouldn't have much of a chance to have much, well, you can have some say, but you certainly could be outvoted.

I would like to ask this Committee, and especially the SBICs and venture capitalists here, in favor of this bill, would you structure a portfolio cutting this financing this way if you were using your own money in place of the Government's? I really doubt it.

COSBI is not privatization, in our opinion. In fact, it represents a greater commitment by the Government than is now available as an in-Government program. Furthermore, we should also consider the effect of COSBI on the Government's risk in the growing amount of the 10-year publicly held SBIC paper, now totaling $238 million, which SBA will continue to guarantee whether COSBI happens or not.

The lack of meaningful regulatory authority over activities of COSBI as an entity, and the elimination of direct Government regulation of individual SBICs and MESBICs, in the face of the substantial continuing Government financial exposure, is in our opinion a most unwise combination. These statutory provisions that would appear to restrain COSBI are vague as to their application, thus giving COSBI wide latitude.

The Government powers, on the other hand, seem narrowly drawn and essentially meaningless due to a lack of enforcement tools. You have to have some enforcement tools if you are trying to govern something and look after it. It is interesting, and this is the interesting part about it, gentlemen of the Senate, to note that

NASBIC's testimony opposes even this meager amount of regulation that you have in the Senate bill. They don't have any in the House. They don't want any control, any regulation, whatsoever.

In fact, this bill appears to create an intolerable situation. The SBIC track record shows the same kind of strengths and weaknesses that are being seen in other types of financial institutions. As with the banking, the savings and loans, and the security industries, experiences with SBICs and MESBICs show, that when a regulator is weak, and the credit is too easy, there are going to be attempts to take advantage of that.

Ultimately the Government must cover big losses to keep individual and institutional investors, who have bought paper in reliance on expressed, or at least implied Federal backing, from financial ruin. I might add that while S. 1929, and, therefore, our discussion of it, makes little reference to the continuing need of our national small business constituency for equity and long-term debt financing on reasonable terms, that has been a problem in mind all the way along. This does a lot of things for SBICs, but how about the sort of businesses that follow and make this work. Who will look after them? Our comments regarding needed regulation and oversight are also made with that end in mind.

There are numerous technical problems in the bill which are described in our full statement.

In closing, once again I want to emphasize that I did not come here to criticize the SBIC Program, which by-and-large has been an exemplary program over the years. Certainly this cooperative effort which began 30 years ago has brought about marvelous achievements in the formation and the growth of dynamic small businesses which likely could not have occurred otherwise. Of equal importance, I didn't come here to oppose the privatization of these programs if that would mean getting the Government out as both financer and administrator. S. 1929 does not even come close to accomplishing that objective because it provides too high a level of immediate and continued Government financial support. At the same time it vests total and immediate control of the program in the SBICs and the MESBICs. It does not provide for effective financial and operating oversight of the program by the Government. Lastly, it eliminates an important present protection that ensures small businesses are treated fairly and that program funds flow to those small businesses who are deserving of Federal assistance. Thus, our opposition to this proposed legislation must stand.

Finally, I would like to compliment you, Senator Weicker, and also the Chairman and the Members of this Committee, for their continuing diligent interest and their active support of the SBA's Programs. We appreciate that very much, the fine work you have done in the past. You both have been champions, the Chairman has been a champion of small businesses down through the years, and with that I guess I will open myself to questions. This should be interesting.

[The prepared statement of Mr. Abdnor follows:]

SBA U.S. Small Business Administration Washington, DC 20416

STATEMENT OF

JAMES ABDNOR

ADMINISTRATOR

BEFORE THE

COMMITTEE ON SMALL BUSINESS

UNITED STATES SENATE

MARCH 31, 1988

Mr. Chairman, we thank you for inviting us to testify this morning on the Small Business Investment Company/Minority Enterprise Small Business Investment Company programs and more specifically on S. 1929, the Corporation for Small Business Investment (COSBI) Charter Act.

S. 1929 is the sixth in a series of bills which have been introduced in the Congress since 1984 which would provide a mechanism enabling the transfer of the SBIC and Section 301(d) SBIC (MESBIC) programs to a newly created corporate instrumentality of the United States which would be owned and controlled by the SBICs and MESBICs.

The proponents of this bill, the trade associations of the SBICs and MESBICs, NASBIC and NAIC respectively, have set forth in testimony on numerous occasions their justifications for this change in the structure of the SBIC and MESBIC programs. First, the uncertainty of the government budgeting process is cited as a major negative factor in the operations of the SBIC and MESBIC programs. Second, the regulatory oversight of the SBA is alleged to have a negative impact on the successful operations of these companies.

In our testimony today we first of all would like to provide you with a brief overview of the current status of the SBIC and MESBIC programs. Then we will discuss our views with respect to the need for an entity such as COSBI, and finally we will offer our specific comments on certain sections of the bill.

Currently there are 307 SBICs with private capital of

$1.5 billion and SBA leverage of $954 million; and 128 MESBICs with private capital of $172 million and SBA leverage of $289.6 million. SBICs are financing small business concerns at an annual rate of $538 million, and MESBICs are providing small business financing at a $143 million annual rate. SBICs generally provide 63% of their financings in the form of equity or debt with equity features while only 20% of MESBIC financings of small businesses involve any equity. SBIC annual financings have risen from $333 million in calendar 1981 to the current annual rate of $538 million or about 62% during the period. MESBIC financings have risen from $54 million in 1981 to the current annual rate of $143 million, an increase of 165% over the same period.

Although the numbers of SBICs and MESBICs has decreased somewhat, the SBIC private capital in the industry has doubled from $713 million in 1981 to $1.5 billion currently. MESBICs had private capital in 1981 of $114 million and have $172 million of private capital currently, an increase of 51%.

It should be noted at this time that 109 SBICs, 36% of those currently operating, with private capital of $536 million or 37% of the program's total private capital, do not use SBA leverage. Further, for the past two fiscal years 1986 and 1987, SBICs did not find it necessary to use $185 million, or

40% of the SBA guarantees authorized by the Congress for those years. So far in FY 1988, with half of the fiscal year expired SBICs have used only 8.4% of their authorized guarantee levels. In contrast, most MESBICs have used SBA leverage primarily because of the substantial subsidy available on those funds, and MESBICs as a group have used 100% of their SBA leverage authority for the same period.

Contrary to testimony provided this Committee on previous occasions by representatives of the SBICs and MESBICs, these statistics demonstrate that generally the SBIC and MESBIC programs have continued to increase their resources, have prospered, and have increased the amount of their financing to this Nation's small business community.

Contrary to the testimony of the SBIC industry representatives that the program's problems began in the 1980's, program performance statistics show more positive progress. For example, of the $7.3 billion of financing provided to the small business community in the 30-year history of the SBIC program, 50% of that has been provided since 1981. Of the $1.6 billion of private capital in the program presently, 49% has come into the program since 1981.

In contrast to the justifications given by the proponents of the bill, it is our view that the SBIC and MESBIC programs have progressed to a point in their respective histories where a graduation to the private sector is called for simply because continued direct hands-on support by the Federal

Government is no longer necessary or justified. Thus, for different reasons, we favor the privatization of the SBIC and MESBIC programs. However, and again contrary to its proponents' assertions, S. 1929 is not privatization. Under COSBI, Federal exposure is increased and oversight reduced on transactions involving billions of dollars.

S. 1929 provides some $1.1 billion direct and indirect financial support to the SBICs and MESBICs through the proposed COSBI entity. This is represented by the proposed $200.0 million of preferred stock capital to be provided by the Treasury, the $150.0 million of cash to be granted the MESBIC trust, the $290.0 million grant of the MESBIC preferred stock and debentures outstanding, and the $500.0 million of indirect back up credit from the Treasury. Not included in this support is the continuing guarantee by SBA initially of approximately $700.0 million on the outstanding SBIC debentures that would be transferred from the Federal Financing Bank and become the asset base for COSBI. Neither the bill nor our analysis addresses the growing amount of SBA-guaranteed SBIC debentures funded through the public sale of SBA-guaranteed participation certificates. The principal amount of these at the present time is $238.[illegible] million. In our opinion, that proposed level of financial support exceeds the present level of financial support that the program receives as an "in-government" program. Privatization in a financial sense would not be accomplished by S. 1929.

While providing that $1.1 billion of direct and indirect Federal financial support, S. 1929 would change the regulatory structure of these two programs from one that is directly monitored and regulated at all levels by SBA through its Investment Division and Inspector General to one that would have the SBICs and MESBICs regulating themselves with a limited amount of fragmented audit and reporting review by SBA, GAO, and the Treasury Department. It is our position that the present level of SBA regulatory, audit, investigative, and enforcement authority with respect to SBICs and MESBICs should be preserved until such time as the Federal financial risk is eliminated.

This Administration categorically opposes the creation of any new government sponsored enterprise (GSEs) like the proposed COSBI. COSBI would have Federal ties and financial arrangements, including the Federal Government's $200 million investment, the $500 million backstop line of credit and perceived close association inherent in all GSEs, which give it special advantages over fully private borrowers in the credit markets. These advantages would enable COSBI to enjoy lower borrowing costs which would constitute implicit Federal subsidies to one special class of borrowers at the expense of all non-subsidized borrowers.

We would also be inclined to oppose any proposal for privatizing SBICs and MESBICs that did not provide for the elimination of continuing Federal financial support with a corresponding elimination of direct Federal regulation. As a start in this direction, for example, any sale of assets from the Federal Financing Bank to COSBI should be without the SBA guarantee on those assets and be without recourse. The price of any such sale should be a market price determined by the Secretary of the Treasury in accordance with standard FFB contractual agreements. Under S.1929, Federal oversight is substantially reduced without a corresponding reduction in Federal financial support.

We have the following comments on specific sections of the bill although these comments do not replace our basic opposition to the bill as set forth in the testimony above.

SIZE STANDARDS. The bill if enacted would increase the size standards for small businesses financed by SBICs. The present size standards require firms financed by SBICs to have net worth of $6,000,000 or less, and average net income, after Federal income taxes, for the preceeding two years of not more than $2,000,000. S. 1929 would increase the net worth ceiling to $8,000,000, and the net income ceiling to $2,500,000. It is our opinion that the standards are more than adequate at the present time. In fact, we have seen SBIC financings under present standards that would indicate present levels may even be excessive. We believe that establishing and regulating size standards for small business eligibility should continue to be the responsibility of SBA.

TRANSFER AND PHASE-OUT. Section 322 of the bill covering "Transfer and Phase-Out" is in our opinion harsh in that it requires SBICs that have not used SBA leverage to either pay a penalty of 1% of their private capital and qualify under COSBI, or to have their license revoked within two years. Many of these SBICs that have not used SBA leverage are the ones that have been responsible for many of the successes in the SBIC program and thus we see no justification for such treatment.

BOARD OF DIRECTORS. Section 352(d) of the bill provides for the establishment of a fifteen member permanent Board of Directors of COSBI. Nine of those Directors would be elected by the SBICs, one would be elected by the Section 301(d) trustee, and the remaining five would be appointed by the President. Thus, two-thirds control would be in the SBIC and MESBIC-elected Directors. Since the Federal Government would be supplying some 90% of the base capital of COSBI, or $200.0 million of the proposed $225.0 million as well as up-front cash grants and considerable indirect financial backing through continuing guarantees on the assets and a back up credit line, we believe that the Executive Branch should appoint a controlling number of Directors. The fact that one of the presidential appointees to the Board would be the Administrator of SBA provides, under those circumstances, little additional comfort.

DISCRETION OVER ASSESSMENTS. Sections 353 (a)(4)(B) and (D) give COSBI discretion over the assessment of SBICs and MESBICs of payments of nonrefundable capital contributions for private capital increases, and increases in borrowings. It is our opinion that there should be no such discretion and thus the word "shall" should be substituted for the word "may" in those subsections.

DIVIDENDS ON COMMON STOCK. Section 353 (a)(5)(D) permits the declaration and payment of dividends to the holders of voting and non-voting common stock. Since the Federal Government will be at substantial financial risk in COSBI by virtue of the guarantee of a major share of its assets, the holding of $200.0 million of non-voting preferred stock, and its exposure under a $500.0 million back-up borrowing power, it is our opinion that no dividends, except dividends declared and paid on the preferred stock held by the Federal Government, should be permitted to be declared or paid until all Federal Government financial risk is extinguished.

CREATION OF SENIOR SECURITIES. Section 353 should include an additional subsection prohibiting the creation or issuing of any equity security senior to the preferred stock to be held by the Federal Government.

ISSUANCE OF COSBI OBLIGATIONS. While Section 354 provides Treasury with some control over the interest rates and terms and conditions (timing) under which COSBI obligations are issued, no Federal control over whether or not obligations may be issued is provided. Authority for such control should be provided to SBA, and extended to include contingent liabilities.

AUTHORITY AND DISCRETION OF THE TREASURY. Section 354 (c) establishes the authority of the Secretary of the Treasury to purchase at his discretion, subject to advance appropriations by the Congress, up to $500.0 million of securities of COSBI. We believe that the bill should restrict this authority and discretion so that such purchases could only be made to avoid a default by COSBI on its debt obligations issued to the public, and that it could not be used to provide funds with which to finance SBICs or MESBICs, or to subsidize their borrowing costs. Further, should such purchases be required under such conditions, the Secretary of the Treasury should have the immediate statutory right to demand security for such borrowings. In addition there should be a mechanism for the government to control COSBI for so long as the borrowing is outstanding.

DEBT TO CAPITAL RATIO. SECTION 354 limits the aggregate amount of COSBI obligations outstanding at any one time to 15 times COSBI's capital, surplus, reserves, and undistributed earnings. Given the riskiness of COSBI's operations, this ratio is excessive. In addition, no limitation on the amount of COSBI's contingent liabilities is provided. In the event that the Treasury backstop line of credit is needed, very high levels of COSBI contingent liabilities could increase the pressure to raise the $500 million Treasury line of credit, thereby creating an unlimited Federal exposure. In addition to the debt to capital ratio, a contingent liability to capital ratio should be included to limit potential Federal exposure.

SPECIAL TREATMENT OF COSBI SECURITIES AND OBLIGATIONS Section 355 provides a number of special benefits for COSBI securities and obligations. Exemption from state and local taxation conveys a State and local government subsidy to COSBI without prior consultation with these government organizations and is a benefit not provided to FNMA and Freddie Mac. COSBI obligations are exempt from SEC regulations and are established as lawful investments and acceptable securities for fiduciary, trust, and public funds. These provisions provide an implicit Federal endorsement for the quality of COSBI securities that promote the expectation that the Federal Government will, if necessary, support the value of these securities.

SUBORDINATION OF SECURITIES ISSUED TO COSBI. Section 356 which covers the loan and investment operations of COSBI should contain a section that requires that any small business investment company debt security purchased by COSBI from an SBIC which at the same time has an outstanding obligation guaranteed by SBA be subordinated as to both principal and interest to the SBIC's SBA-guaranteed borrowing(s).

QUALIFICATION DISCRETION. Section 357(a) presently gives COSBI discretion over the criteria for qualifications of SBICs to conduct business with COSBI. It is our opinion that the criteria should be mandatory. Thus the word "may" in the second sentence of that subsection should be changed to "shall".

PROHIBITION ON SPECULATIVE REAL ESTATE. Section 358(h) prohibits SBIC financing of small concerns for certain enumerated activities. An exception is that financings are permitted for the acquisition of real estate for projects in commercial and residential construction or rehabilitation for sale. We believe that this exception should be eliminated as it permits all types of speculative building which the record shows has been the source of many of the abuses, defaults and potential losses in the SBIC program.

REGULATION, AUDIT, AND INVESTIGATION. Section 358(j) requires, among other things, that at least every two years each SBIC must have a compliance audit by an independent certified public accountant certified or licensed and selected by COSBI, or such audit may be conducted by employees or agents of COSBI. We believe that while any SBIC enjoys the direct or contingent financial support of the Federal Government, such compliance audits should be under the direct control, supervision, and oversight of the Small Business Administration. SBA should have the authority, as it has now, to audit SBICs with its own auditors, or by independent public accountants selected and regulated by SBA through its Office of Inspector General. Enforcement of the regulations should continue to be within the jurisdiction of SBA so long as an SBIC enjoys the benefits of Federal Government direct or indirect financial support.

INSPECTOR GENERAL AUTHORITY. Section 360 provides for audits of COSBI by independent certified public accountants, by SBA, and by the General Accounting Office; and for reports to the Secretary of the Treasury, the SBA and the Congress. That section does not however provide any regulatory, compliance, or enforcement framework for ongoing COSBI operations. The "review" authority granted by subsection (a) would not give SBA any meaningful authority to regulate COSBI nor does it provide any compliance tools or sanctions. Section 360(f) sets forth certain restrictions on the conditions under which the Inspector General of SBA can audit COSBI. It is our opinion that the Inspector General should have unlimited authority to audit the books and records of COSBI as well as each SBIC, and in addition should have the authority to make any investigation of the operations of COSBI or any SBIC doing business with COSBI. These authorities are necessary because the very viability of COSBI would be directly dependent on its proposed direct and indirect financial support by the Federal Government, and thus the safety of the Government's position would be dependent upon the prudent management of COSBI's affairs.

Subsection (h) of Section 360 authorizes SBA to make rules and regulations necessary and proper to ensure that the purposes of COSBI are accomplished. We note the strong opposition to that subsection by the SBIC and MESBIC representatives. SBA does not feel that subsection (h) goes far enough since other parts of Section 360 limit SBA's fact finding ability, and there are no enforcement provisions or sanctions included. The references in this subsection to Title 5, United States Code, further obscure this very limited authority by suggesting that rulemaking would be a quasi-judicial, rather than administrative, procedure.

SALE OF ASSETS AND GRANT TO TRUST. Section 361(a) provides for the sale by the Federal Financing Bank of all of its holdings of SBA-guaranteed SBIC debentures to COSBI for a purchase price of not less than $720.0 million on September 30, 1988, on a full recourse basis, thereby providing COSBI with a continuing Federal subsidy and exposing the Federal Government to a substantial default cost. The $720 million price represents par value; however, the price should be based on the market value of FFB holdings on that date. Thus, this provision would result in windfall gains or losses to the FFB and COSBI. Further, that section stipulates that $200.0 million of the purchase price would be paid by the issuance by COSBI of non-voting preferred stock and that $150.0 million of the cash proceeds of the purchase price would be granted to the Section 359 MESBIC trust as a direct front-end subsidy. This represents a considerable subsidy to COSBI and the MESBIC trust and is thus antithetical to the concept of "privatization".

WARRANTS FOR COSBI NON-VOTING COMMON STOCK. Section 361(d) requires COSBI to issue warrants to the Secretary of the Treasury for the acquistion of COSBI non-voting common stock. The only funding mechanism provided by the bill is for the exchange of preferred stock for the warranted shares of the nonvoting common stock. It is our opinion that the value of the Secretary's option to exchange COSBI preferred stock for its non-voting common stock at the stipulated premium is at best doubtful.

PLEDGE AND HYPOTHECATION OF COSBI ASSETS. Section 361(a) in the next to the last paragraph prohibits COSBI from selling for a period of three years from the date of acquisition the securities acquired from the FFB. To protect the financial position of the Federal Government, we recommend that there be a further restriction for a similar time period on the pledge or hypothecation of those securities.

In the Committee's letter to SBA inviting our testimony, six specific questions were included. Our testimony was already in the clearance process at the time of the receipt of that letter and those questions. Therefore, the answers to those questions, if not covered in the body of our testimony, are provided in the addendum attached to this statement.

IN CONCLUSION, MR. CHAIRMAN, WE BELIEVE THAT IT IS TIME TO WITHDRAW FEDERAL SUPPORT FROM THE SBIC AND MESBIC PROGRAMS IN AN ORDERLY MANNER. HOWEVER, WE MUST OPPOSE S. 1929 BECAUSE IT WOULD NOT ONLY ACTUALLY INCREASE THE FEDERAL GOVERNMENT'S FINANCIAL SUPPORT OF THESE PROGRAMS BUT WOULD AT THE SAME TIME REDUCE ITS ABILITY TO OVERSEE ITS FINANCIAL RISK AND THE EFFORTS OF SBICS AND MESBICS TO ASSIST SMALL BUSINESSES.

Addendum to SBA's Statement of March 31, 1988
Before the Senate Committee on Small Business
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Specific Questions Asked By Invitation Letter

Question #1

We would like you to explain in your testimony whether you believe that COSBI's structure will enable it to serve as a better source of capital for small businesses than the present SBIC Program.

Answer

If the Congress continues to provide authorizations and appropriations in sufficient amounts for the SBIC programs' reasonable needs, and if the budget environment stabilizes, then it is our opinion that the program can continue providing ever increasing amounts of financial assistance to small businesses. One step toward stabilizing the SBIC environment would be to make the program more self-sufficient by increasing guarantee fees. Also, new licensing will resume and the base of SBICs will expand to provide added program coverage.

We do not feel that SBA's level of regulation stifles the activities of SBICs to the extent that financial assistance cannot be provided to small business. There are many SBICs in the program, the great silent majority, that do not find the regulations unreasonable, whose relations with SBA are satisfactory, and that provide financial assistance to small business concerns while at the same time providing their owners with adequate returns for the risks being taken.

Question #2

Further, the Committee must ensure that the Treasury receives a fair return for the debenture (sic) it currently holds. In your opinion, should the sale of the SBIC debenture portfolio to COSBI be sold with recourse, or would a non-recourse sale be preferable?

Answer

This question is answered in the first paragraph of page 7 of the SBA's statement.

Question #3

What costs or savings to the government do you see coming from this legislation?

Answer

There are various elements of costs and savings which must be considered in any evaluation of costs versus savings. Among these on the costs side there are chargeoffs on Section 301(d) grants and gifts, losses on debenture guarantees outstanding, costs of the preferred stock, and the costs of COSBI's borrowing power from the U.S. Treasury.

On the savings side, there is the elimination of the Section 301(d) direct budget, the elimination of the SBIC guarantee authority, and finally, the reduction of administrative expenses.

Any estimate of dollar costs associated with these elements would be heavily influenced by the validity of basic assumptions, and by many internal and external influences in future years. These assumptions and influences will bear heavily on how COSBI will operate and on the quality of its portfolio over time. Because of these imponderables, we do not feel that it is reasonable to make dollar estimates at this time.

The COSBI Charter Act would significantly reduce government oversight and thus would increase the taxpayer risk. We expect that over time, this will be very costly and thus costs would substantially exceed any savings.

Question #4

Are the oversight provisions regulating COSBI's financial performance adequate to protect the interests of the government?

Answer

This question is answered on pages 15, 16, and 17 of SBA's statement.

Question #5

Do the provisions in S. 1929 authorizing SBA to promulgate rules and regulations as necessary to ensure the purposes of the law are upheld, make the Senate bill more preferable than the House version of COSBI?

Answer

This question is answered on the bottom of page 16 and the top of page 17 of SBA's testimony. We oppose both versions of the bill, but the lesser of two evils is the Senate bill.

Question #6

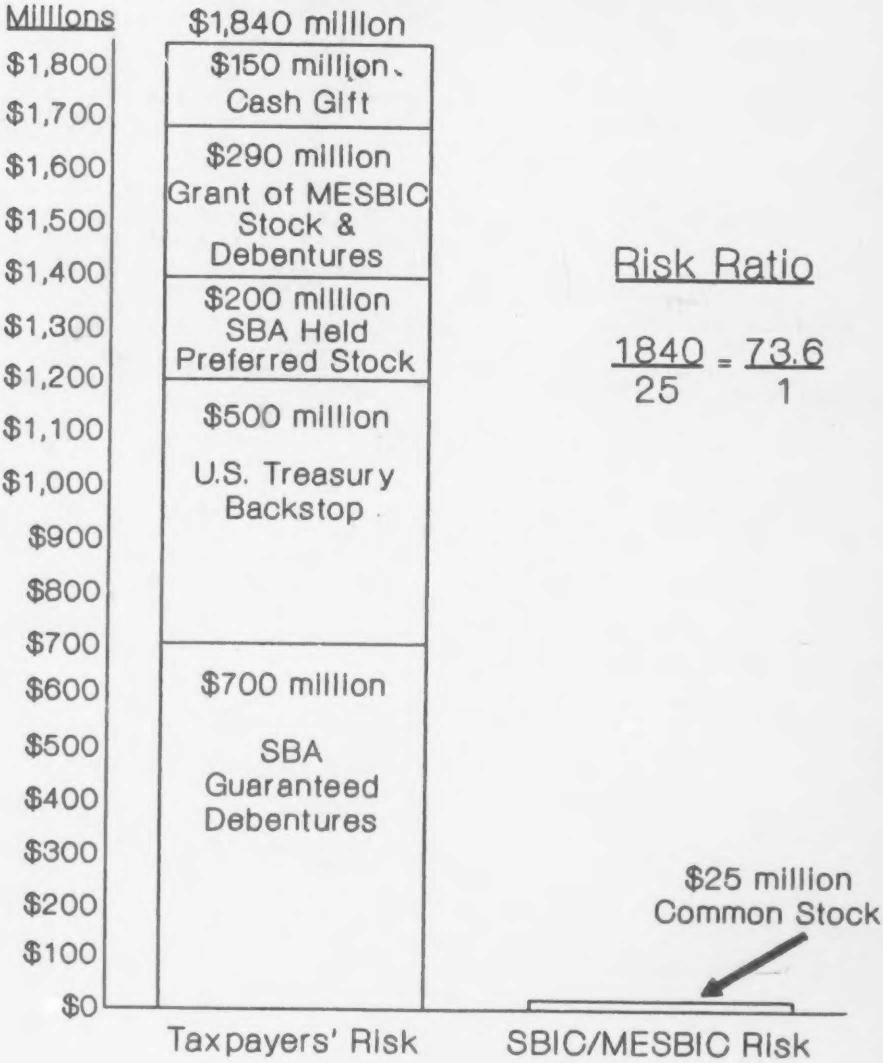
What recommendations or changes would you suggest to the Committee?

Answer

As covered in SBA's testimony specifically on page 6, the Administration categorically opposes the creation of any new government sponsored enterprise like the proposed COSBI. Given that fundamental opposition, suggesting changes would not be appropriate.

Included in SBA's testimony are suggestions for changes that might make the bill less objectionable to the Administration.

Financial Risk Sharing

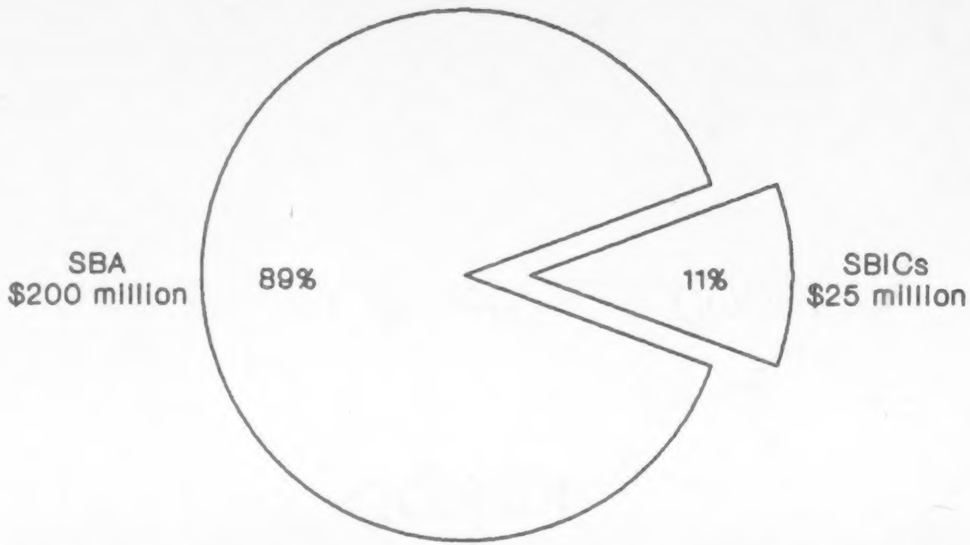


Risk Ratio

$$\frac{1840}{25} = \frac{73.6}{1}$$

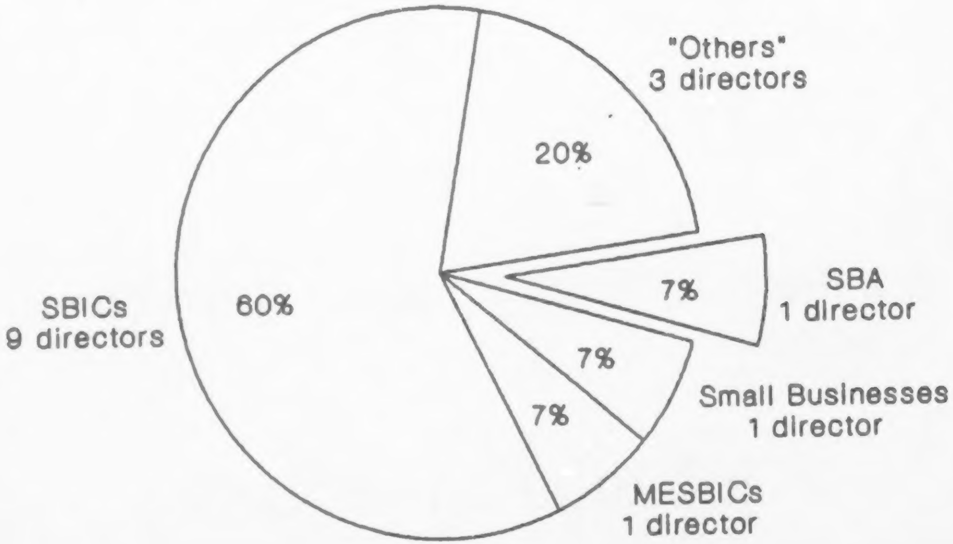
Financial Investment

Common & Preferred Equity Investment



Control

Permanent Directors of COSBI



Control versus Financial Investment

Representing	# of Directors	% of Control	$ Amt of Investment	% of Investment
SBICs	9	60.0%	$25 million	11.1%
301(d)SBICs	1	6.7%	- 0 -	- 0 -
Small Businesses	1	6.7%	- 0 -	- 0 -
"Others"	3	20.0%	- 0 -	- 0 -
SBA	1	6.7%	$200 million	88.9%

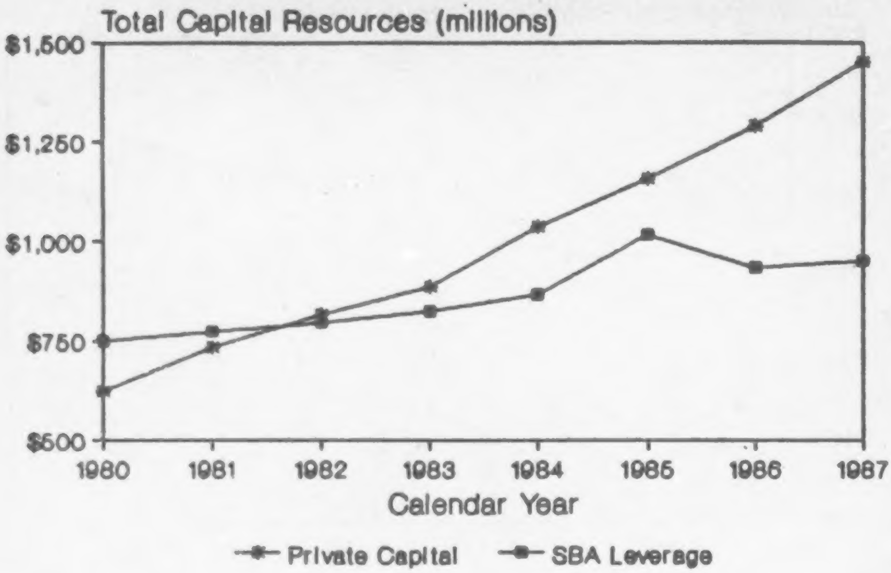
Initial COSBI Financial Resources

Treasury Backstop	$500 million	69.0%	
SBA Investment	$200 million	27.6%	96.6%
SBIC Investment	$25 million	3.4%	

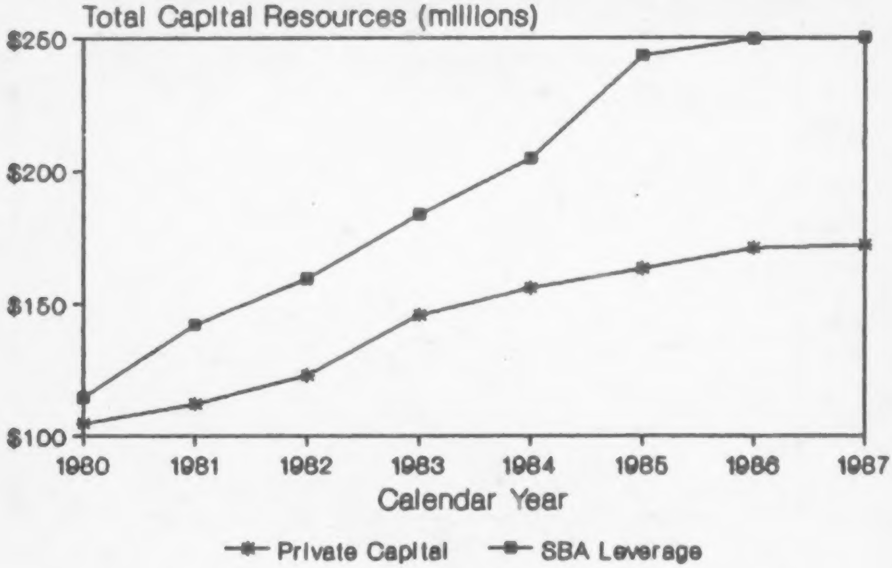
301(d)SBIC Trust Resources

Cash Grant by Gov't	$150 million	34.1%	
Gift of SBA Securities	$290 million	65.9%	100.0%
301(d)SBICs	- 0 -	- 0 -	

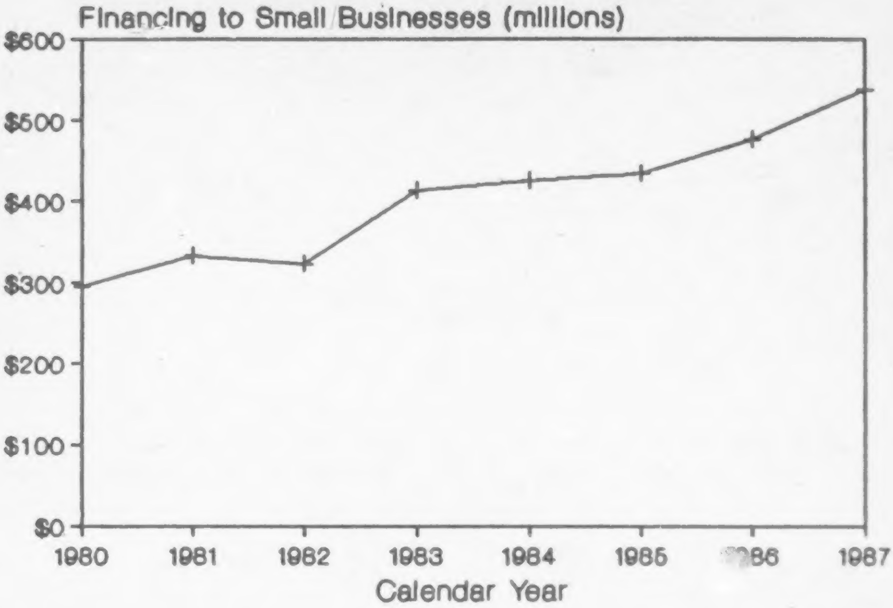
Total Capital Resources of SBICs



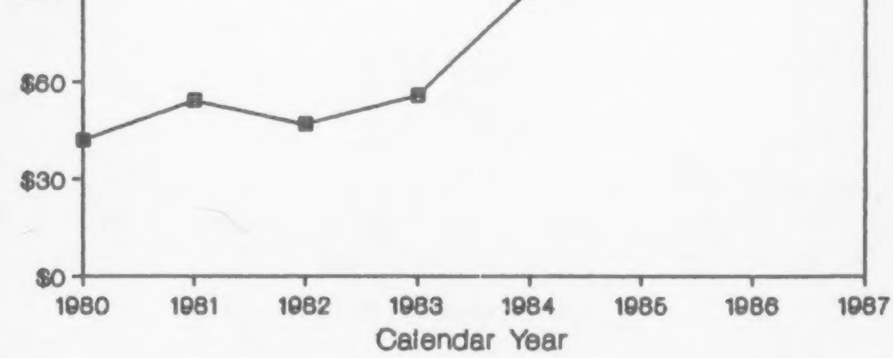
Total Capital Resources of 301(d)SBICs



SBIC Financing by Calendar Year



301(d)SBIC Financing by Calendar Year



Fairness

Section 322 - Transfer & Phase Out

SBICs in Good Standing with No SBA Leverage

- - Sign Up & Pay 1% "Tax" on Capital

OR

- - Get Out of Program in 2 Years

SBICs in Good Standing with SBA Leverage

- - Sign Up & Pay 1% "Tax" on Capital & SBA Leverage

OR

- - Get Out of Program in 2 Years after SBA Debt Paid

Harsh and Heavy-Handed Treatment

Questions for Administrator Abdnor
from Senator Dale Bumpers

1) The Administration raised several objections to COSBI in 1986, some of which I thought were reasonable. In redrafting COSBI in 1987, we made many changes to accommodate the Administration. You asked for more regulatory oversight--S.1929 gives SBA rulemaking power over the Corporation. You asked for a statutory debt to equity ratio--we imposed a D/E ratio of 15 to 1 in this bill, consistent with the statutory treatment of FNMA (Fannie Mae). The bill gives Treasury apecific authority to approve COSBI issuances of debt, as you suggested.

Is the Treasury Department saying it will not support COSBI as a privatization measure, regardless of the improvements this Committee makes to the bill?

Doesn't privatization in this case really mean elimination?

SBA's full statement on S. 1929 sets forth in some detail the reasons why we believe its provisions with respect to regulation of COSBI operations and debt issuance are virtually meaningless. Given the increased level of Federal financial risk embodied in S. 1929 as compared to the existing program, the Inspector General of SBA should have the same full authority to audit and investigate SBICs and MESBICs as at present. While that same authority should also extend to COSBI, we believe that it is no substitute for the ability to directly look at the operations of licensees which is the level at which any problems of unsound or inappropriate uses of funds would likely first occur. In his letter of October 1, 1986, Treasury Secretary Baker said, "There should be a reasonable debt to equity ratio limit on COSBI's borrowings reflecting the credit quality of its assets, which could easily be argued to be as low as 3-to-1 given the default record on SBIC debentures to date."

The Treasury Department should be allowed to speak for itself on the question of whether its support for COSBI is unobtainable under any conditions. However, both SBA and Treasury have provided comments as to which specific sections of this bill and its predecessors should be changed so as to privatize SBICs and MESBICs in a more realistic and responsible manner. None of this commentary suggests or intends their elimination.

2) I know that you can't be blamed for this Administration's abysmal record with respect to SBA before you came on board--in fact, I recall you were a supporter of SBA while in Congress. But what can you say to the SBIC industry's complaints that the Executive Branch can't be relied on as a dependable partner in this program? How can the industry be expected to make business plans for itself and their portfolio companies for years down the road, when the Administration has made effort after effort to liquidate their industry over the past seven years?

Funding levels of Federal discretionary programs are prone to uncertainty, especially in a deficit environment. Because the private capital markets also contain uncertainties, the SBIC industry should factor some uncertainty of funding into their business planning whether or not they are willing to eliminate their dependence on the Federal Government. The budget proposals to eliminate SBA as an independent agency and then to keep it independent but without its credit assistance programs created some uncertainty in the SBIC Program as it did in other potentially affected SBA programs. These proposed reductions were not intended to "liquidate" the industry but to reduce Federal funding. However, the Congress passed new authorization and appropriation legislation to keep the Agency and its programs going. Except for these broad budget proposals which were not specifically aimed at this program, the Administration has requested appropriations for the program each year in amounts about commensurate with anticipated needs.

3) What is the record with respect to new licensees entering the SBIC industry over the last five years? Also, tell us how many SBIC's have turned in their licenses in the last five years.

Please give us the same information with respect to the MESBIC industry.

Please see Attachment # 1 for data on licensing, liquidations, surrenders and revocations from FY 1983 to date. Attachments # 2 and # 3 are also being provided to give a somewhat longer term perspective on the number of licensees and their capital resources.

4) Mr. Administrator, in Treasury Under Secretary Gould's February 24, 1988, letter to the Committee, he states that the value of SBA-owned MESBIC stock, which would be placed in the MESBIC trust within COSBI for continued support of the MESBIC industry, "cannot be determined in advance," but "the subsidy undoubtedly will be measured in billions of dollars when an accounting is made." He is certainly right about the first part, in that the value cannot be determined because the stock has no market value. It pays little or no dividends, it is not traded anywhere, and it was intended and designed as a way to compensate the MESBIC industry for the Congressional goal of increased capital to high-risk, minority-owned businesses. How can it possibly be said in good faith that this is a multi-billion dollar give-away?

Do you agree with Treasury as to the value of the MESBIC stock now owned by SBA?

It would be best for the Committee to ask the Treasury Department to explain the statement in their letter, which appears to us to refer to an ultimate cost to the taxpayers of capitalizing.

subsidizing and covering resulting losses of the MESBIC trust. With respect to the value of the MESBIC preferred stock now owned by SBA, we believe that it only has value to SBA or to an entity such as the MESBIC trust or COSBI that has some ability to enforce its terms.

The MESBIC debentures, which comprise about $110 million of the $290 million total MESBIC securities now held by SBA and are referenced in Mr. Gould's statement, would have a market value to outside parties as well.

Questions for Administrator Abdnor
from Senator Weicker

1. Jim, on page 6 of your statement you state: "This Administration categorically opposes the creation of any new government sponsored enterprises (GSE's) like the proposed COSBI." It is the clear intention of the Chairman and myself to move this bill. Are you telling us today that the Administration will oppose COSBI in any form? If that is the case, it makes it extremely difficult for us to work with you in trying to deal with some of the objections raised in your testimony.

The paragraph to which you refer expresses the Administration's overall opposition to the creation of any new GSE. Our statement does contain specific comments on sections of S. 1929 which we believe to contain structural flaws along with our recommendations for needed improvements. These problems in the present bill are serious enough that we feel they should be addressed by Congress. We will be pleased to discuss these comments and recommendations with you and to work with you and other Committee members and staff to improve this legislation. Even though such efforts may not ultimately win Administration support for this bill, they could make it a better balanced proposal and thereby reduce the taxpayers' exposure to the risk accompanying the creation of COSBI.

2. You expressed concern that 10 of the 15 members of the Board of Directors are elected by SBICs and MESBICs. You argue that the executive branch should appoint a controlling number of directors. What other GSE's have public members controlling?

To the best of our knowledge, only the Federal Home Loan Bank System entities including its conventional mortgage secondary market arm (Freddie Mac) and the bank board (FHLBB) itself are controlled by Presidentially appointed directors. However, none of those entities nor Fannie Mae or Sallie Mae have any government ownership. Further, we note that the Farm Credit System, the heart of which consists of the Farm Credit Banks owned by farm cooperatives and credit associations, is supervised by the Farm Credit Administration of the Department of Agriculture.

3. This bill differs significantly from previous versions of COSBI. For example, this bill requires COSBI to have a 15:1 debt to capital ratio; Treasury is authorized to approve all of COSBI's debt issues; the government is given access to all of COSBI's books and records, and SBA is given general regulatory authority over COSBI. These provisions were included to address concerns raised by Secretary Baker in his letter to me opposing the House-passed version of the reconciliation bill in 1986. Do you have specific recommendations on provisions of the bill which ought to be changed or is the Administration simply going to continue its philosophical opposition to the SBIC/MESBIC industries?

A re-reading of Secretary Baker's letter indicates that a 15:1 debt to capital ratio for COSBI is too high to resolve his concern and his comment that a reasonable debt to equity ratio limit on COSBI's borrowings reflecting the credit quality of its assets might be as low as 3:1. His comment most certainly did not contemplate that 89% of the equity side of the ratio would come from the government's purchase of preferred stock in COSBI. The Administration opposes the creation of COSBI, not the SBIC/MESBIC industries. COSBI, as presently proposed by S.1929,would provide substantial Federal support for SBICs and MESBICs and expose the taxpayer to great financial risk without providing the Government with sufficient authority to protect itself. SBA's statement contains specific comments and recommendations regarding shortcomings of S. 1929's provisions for COSBI'S debt to capital ratio and regulatory authority of the government that would help mitigate this risk.

4. Jim, I note that SBA and Treasury both refer to the $500 million backstop as a "line of credit." On page 11 of your prepared statement you recognize that the language of the bill makes the exercise of the Treasury's discretion subject to an advance appropriation by the Congress. Yet, you recommend that the bill should further restrict this authority. If the Congress must give advance appropriations, presumably it would follow a review of the facts and discussions with the Treasury and others in the Administration.

First, what other GSE requires an appropriation of the Congress before the Secretary of the Treasury can exercise the backstop?

Secondly, why do you believe more restrictive statutory language should be added if an advance appropriation is necessary?

To the best of our knowledge, only the new Farmer Mac GSE specifically requires an advance appropriation before its line of credit with Treasury can be drawn upon. However, we would question whether the Secretary of the Treasury could provide any substantive amount of funds under the other GSEs'credit lines unless Congressionally appropriated funds were available or the debt ceiling adjusted for that purpose.

In response to the second part of your question, we believe that both the Secretary and the Congress would find it virtually impossible to deny funds under the credit line if COSBI encountered financial difficulties that would jeopardize individual and institutional investors who had purchased its paper. As you know, S. 1929 deems COSBI to be an agency of the United States and its obligations to be obligations of the United States and thus acceptable to satisfy reserve requirements of banks and savings and loan associations as well as other fiduciary and trust requirements. The greater inherent risk in the underlying portfolio of COSBI as compared to the mortgage and guaranteed loan portfolios of other GSEs increases the likelihood that COSBI'S backup credit line would have to be drawn against. We therefore recommended on page 11 of our statement that use of the credit line be restricted to avoiding default on COSBI'S public debt obligations and that the Secretary of the Treasury be given the ability to secure borrowings under the credit line as well as control COSBI while such borrowings were outstanding. We believe this would clarify for all parties the circumstances under which COSBI might borrow from Treasury, encourage more careful management of COSBI and better control the government's exposure on the credit line.

Attachment No. 1*

1. LICENSING ACTIVITY

*Private Capital in Millions

	SBICs		301(d)SBICs	
FY	NO	PRI.CAP*	NO	PRI.CAP
1983	34	$37.8	23	$12.8
1984	48	107.4	12	11.2
1985	35	76.3	13	14.1
1986	12	21.6	5	5.0
1987	20	110.8	10	10.5
Oct. 1, '87 - April 15, '88	9	49.7	1	1.0
Totals	158	$403.6	64	$54.6

2. TRANSFERS TO LIQUIDATION

	SBICs	301(d)SBICs
FY	NO	NO
1983	9	4
1984	7	6
1985	3	4
1986	18	8
1987	25	12
Oct. 1, '87 - April 15, '88	5	6
Totals	67	40

3. VOLUNTARY SURRENDERS

	SBICs	301(d)SBICs
FY	NO	NO
1983	16	5
1984	24	4
1985	25	7
1986	23	2
1987	16	4
Oct. 1, '87 - April 15, '88	9	1
Totals	113	23

4. LICENSE REVOCATIONS

	SBICs	301(d)SBICs
FY	NO	NO
1983	0	0
1984	0	1
1985	0	0
1986	1	1
1987	3	0
Oct. 1, '87 - April 15, '88	1	0
Totals	5	2

Attachment #2

SBIC & MESBIC Licensing Activity by Fiscal Year
Fiscal Years 1974 to 1987
($ in millions)

Fiscal Year	SBICs		MESBICs		COMBINED	
	#	Private Capital	#	Private Capital	#	Private Capital
1974	16	$16.6	6	$2.3	22	$18.9
1975	13	$8.6	16	$7.5	29	$16.1
1976	15	$7.8	8	$5.8	23	$13.6
1977	27	$22.3	9	$4.1	36	$26.4
1978	37	$29.5	19	$12.4	56	$41.9
1979	45	$66.6	31	$13.8	76	$80.4
1980	37	$49.6	23	$12.2	60	$61.8
1981	44	$59.0	21	$13.2	65	$72.2
1982	30	$33.8	8	$5.6	38	$39.4
1983	34	$37.8	23	$12.8	57	$50.6
1984	48	$107.4	12	$11.2	60	$118.6
1985	35	$76.3	13	$14.1	48	$90.4
1986	12	$21.6	5	$5.0	17	$26.6
1987	20	$110.8	10	$10.5	30	$121.3

Attachment #3

Licenses Outstanding and SBIC Program Capital Resources Fiscal Years 1977 to 1987 ($ in millions)

Fiscal Year Ended		#	Private Capital	Leverage	Capital Resources
Sept. '77 -	SBICs	273	$428.3	$536.9	$965.2
	MESBICs	84	$50.4	$65.8	$116.2
		357	$478.7	$602.7	$1,081.4
Sept. '78 -	SBICs	294	$448.1	$576.8	$1,024.9
	MESBICs	86	$61.9	$60.3	$122.2
		380	$510.0	$637.1	$1,147.1
Sept. '79 -	SBICs	325	$541.6	$635.3	$1,176.9
	MESBICs	110	$79.4	$92.8	$172.2
		435	$621.0	$728.1	$1,349.1
Sept. '80 -	SBICs	338	$596.3	$735.1	$1,331.4
	MESBICs	121	$96.1	$109.8	$205.9
		459	$692.4	$844.9	$1,537.3
Sept. '81 -	SBICs	362	$713.0	$761.6	$1,474.6
	MESBICs	130	$114.2	$141.1	$255.3
		492	$827.2	$902.7	$1,729.9
Sept. '82 -	SBICs	356	$765.6	$796.1	$1,561.7
	MESBICs	127	$121.4	$164.8	$286.2
		483	$887.0	$960.9	$1,847.9
Sept. '83 -	SBICs	360	$872.2	$825.3	$1,697.5
	MESBICs	144	$139.7	$178.4	$318.1
		504	$1,011.9	$1,003.7	$2,015.6
Sept. '84 -	SBICs	381	$977.8	$835.1	$1,812.9
	MESBICs	146	$150.1	$183.0	$333.1
		527	$1,127.9	$1,018.1	$2,146.0
Sept. '85 -	SBICs	387	$1,119.6	$963.4	$2,083.0
	MESBICs	148	$165.8	$229.9	$395.7
		535	$1,285.4	$1,193.3	$2,478.7
Sept. '86 -	SBICs	344	$1,282.8	$1,002.4	$2,285.2
	MESBICs	137	$166.2	$237.4	$403.6
		481	$1,449.0	$1,239.8	$2,688.8
Sept. '87 -	SBICs	317	$1,447.1	$960.4	$2,407.5
	MESBICs	135	$182.0	$258.7	$440.7
		452	$1,629.1	$1,219.1	$2,848.2

Senator **Weicker**. Thank you very much, Jim. I think you make a very strong case, I might add, for your point of view. I will bring these charts back in just a minute.

Why don't we hear first from Mr. Sethness and then possibly we can ask the same questions for both of you.

STATEMENT OF HON. CHARLES O. SETHNESS, ASSISTANT SECRETARY FOR DOMESTIC AFFAIRS, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. **Sethness**. I have not only the same questions but the same points of view. I tried to cut down the prepared statement while listening here. I think really the best thing to do is not to compete with the eloquence and articulateness of my colleague at the table, but say we are in full support of all of those positions and have been all along and have repeatedly commented in some considerable detail on the Treasury Department's piece of the Administration opposition to S. 1929 and its predecessors, and I will leave it for questions now with the statement that our conviction that that opposition is well deserved stands.

Senator **Weicker**. Your statement in its entirety will be placed in the record.

[The prepared statement of Mr. Sethness follows:]

FOR RELEASE ON DELIVERY
EXPECTED AT 9:30 A.M.
March 31, 1988

STATEMENT OF THE HONORABLE CHARLES O. SETHNESS ASSISTANT SECRETARY OF THE TREASURY (DOMESTIC FINANCE) BEFORE THE SENATE COMMITTEE ON SMALL BUSINESS

Mr. Chairman and members of the Committee, I am pleased to be here today to discuss S. 1929, the "Corporation for Small Business Investment Charter Act."

S. 1929 would create a Government-sponsored private Corporation for Small Business Investment, COSBI, that would serve as a secondary market and warehousing facility for loans to and investments in Small Business Investment Companies. The bill would also establish a special small business investment companies (MESBIC) trust. The MESBIC trust and COSBI would operate a special SBIC subsidy program similar to the current Minority Enterprise Small Business Investment Company program.

We strongly oppose S. 1929. As Secretary Baker indicated in his October 1, 1986 letter to your Committee concerning a similar COSBI proposal, we generally are opposed to the creation of a new Government-sponsored enterprise. While S. 1929 has been described as a privatization measure, COSBI would not be a truly private enterprise, and its receipts and outlays would be included in the budget totals for the indefinite future.

The proposed "private" COSBI would assume the current role of the Small Business Administration in financing SBICs, and would do so with strong Federal financial backing as well as other benefits typically afforded to Federal agencies. At the same time, however, COSBI would not be subject to the same level of oversight and control of its spending, borrowing, lending and other activities as are SBA and other Federal agencies. Thus, COSBI may consider itself free to dissipate its resources in the belief that Congress, as in the recent Farm Credit System example, may take supportive action.

To finance its activities, COSBI would be authorized to issue voting common stock that SBICs would be required to purchase; non-voting common stock; preferred stock; warrants to Treasury that would be convertible into common stock; senior debt obligations to the public and the Treasury; subordinated obligations to the public; and participations or pooled interests in its assets, including assets guaranteed by SBA. Although the authority to borrow from the Treasury has been described as a backstop for COSBI's financial obligations, the bill contains no restriction on the use of the borrowing authority. Thus, COSBI could borrow from Treasury for any of its authorized purposes, including salaries and administrative expenses.

We are particularly concerned that only the issuance of debt obligations would be subject to the approval of the Secretary of the Treasury. All other forms of COSBI's direct and contingent liabilities, however, would not be subject to Treasury approval.

Thus, by simply changing the designation of a financial instrument from "debt" to "participation," the Corporation could escape the Treasury approval requirement, with potentially disruptive consequences for the market for Federal and federally-related securities, and the debt-to-equity limit. We also note that the aggregate amount of debt obligations issued under the bill would be limited to 15 times COSBI's capital, unless a higher ratio is established by the SBA. Even if applied to all direct and contingent liabilities, this debt-equity ratio is extremely high, particularly in light of the approximate 1-out of-3 default experience under the existing SBIC program. This will increase the likelihood of a future congressional rescue. Given the high default experience under the existing SBIC program, we would not expect COSBI to perform as well as Fannie Mae, with its 50-year long track record in the secondary mortgage market, and Sallie Mae, the assets of which are guaranteed by State agencies with Federal backing.

COSBI's initial asset base would be backed by the full faith and credit of the United States. No later than October 1, 1988, the Secretary of the Treasury would be required to sell to COSBI the Federal Financing Bank holdings of SBA-guaranteed SBIC debentures, which would continue to be guaranteed by SBA after sale. The final purchase price of the debentures could not be less than $720 million, irrespective of the value of the FFB holdings on the date of sale. This would result in windfall gains or losses to the FFB and COSBI, depending on market conditions at the time of sale. Moreover, the FFB would receive only about half of the proceeds of the sale in cash. Immediately upon sale, $150 million of the proceeds would be transferred to the MESBIC trust outside of the normal budget/ appropriations process. An additional $200 million would be in the form of COSBI preferred stock. Dividends on preferred stock would be used to augment the resources of SBA's existing Business Loan and Investment Fund, also outside of the normal budget/appropriations process.

If the proposed sale of FFB holdings of SBIC debentures were to take place, it should be in accordance with the procedures followed in the Administration's loan asset sales program. Under such procedures, SBA would purchase the debentures from the FFB at a market price in accordance with existing contractual agreements with the FFB. The loans would then be sold by SBA to the COSBI without recourse. Thus, the costs associated with the transaction would be reflected on the books of SBA, the program agency, and not on the books of the FFB, the financing intermediary. In this way, proper program cost accountability would be achieved. Such accountability is a primary tenet of the Administration's credit reform proposal.

The above procedures were followed by the Farmers Home Administration in its sale of community development and rural housing loans in 1987. These sales were made on a nonrecourse basis. The Administration is firmly committed to nonrecourse sales of loan assets. Although the Government would receive higher proceeds at the time of sale if the loans were guaranteed, these additional proceeds would be offset in the future as defaults on the guaranteed loans occur, resulting in Federal payments under the guarantee contracts.

The MESBIC trust, which would be under the control of four industry representatives and one presidential appointee, would receive SBA's existing portfolio of MESBIC preferred stock and debentures without compensation to SBA. While the value of this giveaway cannot be determined in advance, the subsidy undoubtedly will be measured in billions of dollars when a final accounting is made following the redemption of all preferred stock and debentures.

The trust would be used to cover losses on MESBIC debentures purchased or guaranteed by COSBI, to buy down interest rates on MESBIC debentures, and to purchase MESBIC preferred securities. Since COSBI's losses on its purchases or guarantees would be covered by the trust, there would be little incentive for COSBI to scrutinize the credit worthiness of MESBIC issuers. Moreover, although the trust corpus would revert to the Treasury at the end of the trust's 50-year life, there is little reason to believe any amounts would be returned to the Treasury because the trust would be controlled by industry representatives.

Under existing budget scoring rules applicable to government-sponsored enterprises, COSBI's receipts and outlays would be included in the Federal budget. Thus, the absence of Administration and Congressional controls over the spending activities of COSBI will only exacerbate the problems of budget control and deficit reduction.

In view of the foregoing, the Department is strongly opposed to S. 1929, and would recommend that the President veto S. 1929 or any similar legislative proposals.

This concludes my prepared statement. I will be glad to answer any questions you may have.

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Questions from Senator Bumpers Concerning
Assistant Secretary Sethness' Testimony on S. 1929

Question #1:

The Administration raised several objections to Cosbi in 1986, some of which I thought were reasonable. In redrafting Cosbi in 1987, we made many changes to accommodate the Administration. You asked for more regulatory oversight--S. 1929 gives SBA rulemaking power over the Corporation. You asked for a statutory debt to equity ratio--we imposed a D/E ratio of 15 to 1 in this bill, consistent with the statutory treatment of FNMA (Fannie Mae). The bill gives Treasury specific authority to approve Cosbi issuances of debt, as you suggested.

Is the Treasury Department saying it will not support Cosbi as a privatization measure, regardless of the improvements this Committee makes in the bill?

Does privatization in this case really mean elimination?

Answer:

As I indicated in my testimony on S. 1929 before your Committee, the proposed Corporation would not, in any meaningful sense, be a private enterprise because of the strong Federal financial backing and other special benefits which it would receive. Moreover, the proposed limited oversight and control of the spending, borrowing, lending, and other activities of the Corporation would not adequately protect the Federal Government's extensive financial interest in the Corporation and could lead to disruptive impacts in the market for Federal and federally-related securities. Because of these fundamental problems with the bill, we oppose it.

In your question, you cite a number of "improvements" which were made to the bill in order to provide Federal oversight and control of the Corporation. As I pointed out in my testimony, the bill, as amended, however, would not provide adequate Federal oversight and control of the Corporation. For example, the issuance of senior debt obligations of the Corporation would be subject to Treasury approval and the aggregate amount of senior debt obligations outstanding would be limited to 15 times the capital of the Corporation, unless SBA set a higher ratio, however, all other forms of direct and contingent liabilities of the Corporation would not. Thus, by simply changing the designation of a financial instrument from, say, "debt" to "participation", the Corporation could escape the Treasury approval requirement, with potentially disruptive consequences for the market for Federal and federally-related securities, and the debt-to-equity limit, increasing the likelihood of a future

Congressional rescue. Moreover, even if applied to all direct and contingent liabilities, the 15 times equity ratio is extremely high, in light of the approximately one-in-three default ratio under the existing SBIC program. For this reason, Secretary Baker recommended a 3-to-1 debt-to-equity ratio on COSBI's borrowing in his October 1, 1986 letter to your Committee on an earlier COSBI proposal.

As I indicated at the hearing, given our fundamental concerns with the bill, technical modifications to the bill might make the bill more palatable to the Administration, but they would not result in Administration support for the bill.

BUMPERS

Question #2:

If the Government is so opposed to the creation of new GSE's, why did the President sign legislation creating five new GSE's or GSE-like organizations over the last year and a half? (Three for Farm Credit, one for the Thrift industry and one for student housing loans, called Connie Lee).

Answer:

We are generally opposed to the creation of new GSE's because we do not feel that new GSE's are necessary or useful. They often hide new Government subsidies under a "private sector" label. Five new entities created within the past two years have been preliminarily designated as GSE's in the 1989 budget. These entities are as follows:

The College Construction Loan Insurance Association
The Financing Corporation
The Federal Agricultural Mortgage Corporation
The Farm Credit System Financial Assistance Corporation
The Farm Credit System Insurance Corporation

The first of these entities, which has been called Connie Lee, is organized as a private, for-profit insurance corporation to guarantee and insure bonds and loans made for construction and renovation of college and university facilities, and was authorized to be established by the Higher Education Amendments of 1986. This legislation was an omnibus bill which extended and amended the basic Higher Education Act authorities necessary to provide assistance to deserving students and support important programs. Thus, it was signed by the President in spite of the Administration's concerns regarding the creation of Connie Lee.

The Financing Corporation was established to recapitalize the Federal Savings and Loan Insurance Corporation. In signing the bill which authorized the Financing Corporation, the President indicated that the legislation would accomplish the necessary recapitalization of the FSLIC without increasing the budget deficit, because industry resources would be relied upon rather than taxpayer funds.

The last three entities listed above were authorized by the Agricultural Credit Act of 1987, which requires sweeping changes in the Farm Credit System and was enacted to provide a long-term solution to a persistent agricultural crisis. The Federal Agricultural Mortgage Corporation, which will guarantee the timely repayment of principal and interest on pools, or obligations backed by pools, of qualified loans, was strongly resisted by the Administration.

BUMPERS

Question #3:

Under Secretary Gould's February 24, 1988, letter to the Committee states that the value of SBA-owned MESBIC stock, which would be placed in the MESBIC trust within Cosbi for continued support of the MESBIC industry, "cannot be determined in advance," but "the subsidy undoubtedly will be measured in billions of dollars when an accounting is made." He is certainly right about the first part, in that the value cannot be determined because the stock has no market value. It pays little or no dividends, it is not traded anywhere, and it was intended and designed as a way to compensate the MESBIC industry for the Congressional goal of increased capital to high-risk, minority-owned businesses. How can it possibly be said in good faith that this is a multi-billion dollar give-away?

Answer:

Under S. 1929, the existing $290 million portfolio of MESBIC debentures and preferred stock would be transferred from SBA to the proposed MESBIC trust without compensation to SBA. One method of valuing this subsidy is to consider the interest costs to the Treasury. If the Department received the $290 million in return for the portfolio at time of the transfer, the Treasury's borrowing requirements would be reduced by that amount. At the current long-term Treasury cost of borrowing of about 9 percent, the reduced borrowing requirement would result in interest savings to the Treasury of about $26 million per year. Thus, at the end of the fifty-year life of the Trust, the interest savings foregone, or interest cost to the Treasury, would amount to approximately $1.3 billion.

Questions from Senator Weicker Concerning Assistant Secretary Sethness' Testimony on S. 1929

Question #1:

Mr. Sethness, please explain the role of the Treasury in approving the issuance of other GSE securities. (They have said Treasury acts more like a traffic cop, essentially approving the timing for GSE's to go to the market so that they don't conflict with other government issues.)

Does the Treasury ever stop a GSE from going to the market for policy reasons?

You say on the bottom of page 2 of your prepared statement that you are concerned that under the bill all forms of COSBI's direct and contingent liability would not be subject to Treasury approval. Does Treasury have such authority over other GSE's?

Answer:

The Treasury approves the timing and terms of debt obligations issued by the Federal Home Loan banks, Federal National Mortgage Association, Student Loan Marketing Association and the Financing Corporation (established to recapitalize the Federal Savings and Loan Insurance Corporation). The Farm Credit system and the Federal Home Loan Mortgage Corporation consult with Treasury on the timing and terms of their securities issues.

Treasury approvals and consultations coordinate the timing of sponsored agency securities issues to assure that financings are accomplished in a way that is least disruptive to the markets. In this connection, agencies have been required to delay offerings of debt securities from time to time. Treasury does not determine whether a particular issuance strategy or amount of debt outstanding is appropriate to the business operations of a particular sponsored agency, although other Federal agencies, such as the Farm Credit Administration in the case of the Farm Credit System, do have such oversight authorities.

While the Treasury approval process generally is a "traffic cop" function, it also has been used to require the use of registered or targeted-registered offerings by the sponsored agencies that borrow abroad (as opposed to offerings in bearer form), so long as an entity retains its Federal ties.

WEICKER

Question #2:

In response to the issues Secretary Baker raised in his letter of opposition to COSBI last Congress, we made several important changes in S. 1929 including:

- the establishment of a debt-to-equity ratio limit on COSBI borrowing.
- the authority of Treasury to approve the issuance, as well as the terms and conditions of COSBI debt.

Do these changes alter your view of COSBI?

Answer:

No. In my testimony on the bill, I pointed out that the proposed Treasury approval requirement and the debt-to-equity ratio were deficient. Under the bill, the issuance of senior debt obligations of the Corporation would be subject to Treasury approval and the aggregate amount of senior debt obligations outstanding would be limited to 15 times the capital of the Corporation, unless SBA set a higher ratio, however, all other forms of direct and contingent liabilities of the Corporation would not. Thus, by simply changing the designation of a financial instrument from, say, "debt" to "participation", the Corporation could escape the Treasury approval requirement, with potentially disruptive consequences for the market for Federal and federally-related securities, and the debt-to-equity limit, increasing the likelihood of a future Congressional rescue. Moreover, even if applied to all direct and contingent liabilities, the 15 times equity ratio is extremely high, in light of the approximately one-in-three default ratio under the existing SBIC program. For this reason, Secretary Baker recommended a 3-to-1 debt-to-equity ratio on COSBI's borrowing in his October 1, 1986 letter to your Committee on an earlier COSBI proposal.

We strongly oppose the creation of the proposed corporation, since it would not be a truly private enterprise because of the strong Federal financial backing and other special benefits which it would receive. Moreover, the proposed limited oversight and control of the spending, borrowing, lending, and other activities of the Corporation would not adequately protect the Federal Government's extensive financial interest in the Corporation and could lead to disruptive impacts in the market for Federal and federally-related securities. Given our fundamental concerns with the bill, technical modifications to the bill might make it more palatable to the Administration, but they would not result in Administration support.

WEICKER

Question #3:

Under the Administration's loan asset policy, of course, COSBI would purchase the SBIC portfolio without recourse. The Chairman and I both agree that in most instances that non-recourse sales waste government assets. Under the bill, COSBI would purchase the SBIC portfolio for at least $720 million with recourse. Don't you think the financial soundness of COSBI would be strengthened by a recourse sale of SBIC debentures?

Answer:

Yes. The financial soundness of COSBI would be strengthened by a recourse sale of SBIC debentures, since its entire initial asset base would be backed by the full faith and credit of the United States. However, as I pointed out in my testimony, the Administration is firmly committed to nonrecourse sales of loan assets. Although the Government would receive higher proceeds at the time of sale if the loans were guaranteed, these additional proceeds would be offset in the future as defaults on the guaranteed loans occur, resulting in Federal payments under the guarantee contract. Given the high default experience under the existing SBIC program, this is an important consideration. We, therefore, oppose the proposed recourse sale of the SBIC debentures to COSBI.

WEICKER

Question #4:

You suggest that the portfolio should be sold for "market value". The bill, under section 361(b), sets out a procedure for establishing a purchase price for the portfolio. Doesn't having two of three investment banking firms agree on the purchase price establish a "market value" for the portfolio?

Answer:

In my testimony on the bill, I stated that if the proposed sale of FFB holdings of SBIC debentures were to take place, it should be in accordance with the procedures followed in the Administration's loan asset sales program. Under such procedures, SBA would purchase the debentures from the FFB at a price determined in accordance with existing contractual agreements with the FFB. The debentures would then be sold by SBA to COSBI without recourse at an agreed upon price. Under this approach, the costs of the sale would be reflected on the books of the program agency, SBA, and not the FFB, the financial intermediary.

Under the existing contractual agreements with the FFB, SBA would be required to purchase the SBIC debentures at a price determined by the Secretary of the Treasury to be equal to the present value of the remaining payments on the SBIC debentures discounted at a rate determined by the Secretary, taking into consideration current market yields on outstanding marketable obligations of the United States of comparable maturity.

The price at which SBA would then sell the SBIC portfolio to COSBI without recourse could be established using an arbitration procedure similar to the one proposed in S. 1929. Having two out of three investment banking firms agree on the purchase price is one way to establish a "market value" for the portfolio. However, as I pointed out in my testimony on the bill, setting a floor of $720 million for the final purchase price of the portfolio, as proposed by the bill, would result in windfall gains or losses to the seller of the portfolio and COSBI.

Senator **Weicker**. Now, let's bring back the chart. The questions that I have relate to the financial risk-sharing. I accept everything you have there except one aspect that is a little bothersome to me.

In your testimony you cite the Federal Government has $1.8 billion financial risk in COSBI. That number includes the $700 million in guaranteed debentures currently being held at the FFE that would be sold to COSBI with recourse. So, S. 1929 in no way changes the Federal Government's potential liability on these debentures. Don't you think that it is a little misleading to incorporate that figure in the financial risk assessment, because the Government already has that risk today?

Mr. **Abdnor**. Yes, but if COSBI goes into place we lose control of that. We have now the ability to go after that and see that it is repaid. We lose all of that if we turn it over. However it is treated, we have no control over who is going to handle it or how they are going to handle it or how generous they are going to be. There is great movement afoot now to do a lot of forgiving. That may be good, but it is costly and many of these debts can be collected if you call them a little, and keep after them. That is the thing that we need. We lose practically all control of everything, including the money we may be putting in there, the up-front money, that $200 million stock we have to buy.

Can you imagine, Mr. Chairman, yourself going into a business where you would put up $200 million and the other group might put up anywhere from $20 to $25 million for starting up a company where you have five directors at the best, and maybe not if the other four don't come through for you. You are sitting there supposed to be head of the SBA, and these 10 other people who run this thing can do anything they want to, can outvote you, can do anything, and that is what we have here. It just doesn't look like it is a very equitable way of starting out with Government funds.

And with the track record that we are looking at today, they are bailing out savings and loans and they are bailing out, well, Farmer's Home gave up $7 billion worth of our money the other day. Maybe we will be doing this, I don't know, it costs money even today, but this could get to be a greater cost and that is what bothers us. It has been a good program for the last 7 years. It has worked, not perfectly maybe, but we think pretty well, and I know the growth of it shows it. We realize there is risk and we have been taking this risk, but here we put up the dollars and have no control and it is all risk.

Senator **Weicker**. Let's get down to the real question. I think you make a very impressive case. Now that I see this presented graphically, with your figures before the Committee and your reasons, I think obviously there ought to be an adjustment. What I want to know is whether this can be adjusted to the point that it will receive the support of Treasury and the Small Business Administration or whether we are really just sitting here wasting each other's time in the sense that, no matter what the ratios, the concept is going to be opposed by the Administration?

Mr. **Abdnor**. I would like to give you a very honest answer to that, but I don't know if I can right now. I don't know whether we can agree, but I would like to sit down and try it. I have got to believe there must be some give and take.

Senator WEICKER. I have heard that really the Administration is just against it.

Mr. ABDNOR. I won't even try to answer that.

Senator WEICKER. If that is the case, there is no point in going back and forth because I would agree, as I see this visually presented to me, I think it ought to be adjusted. I think it ought to be adjusted. So I am not coming at you with Senator Bumpers and my bill, saying take it or leave it. I am saying I think clearly there ought to be some give and take here. Are you prepared to enter into that or are we wasting each other's time?

Mr. ABDNOR. From my end I would like to enter into it, but I can't speak about how the Treasury feels about it.

Mr. SETHNESS. The Treasury and the rest of the interagency process and the Administration is likely to come up with continuing problems with a newly-created enterprise that has ties to the Government, but there is still a long way to go, and if you want to put it in terms of making steps to make it less objectionable, would you finally find that you get endorsement? Probably not, but even in doing something that isn't going to get final support and endorsement, it has to be worth the effort to put together something that actually makes sense, doesn't create undue risks and might work in a way that makes sense for the communities we are trying to serve.

Senator WEICKER. Let me say this, I know that the SBIC/MESBIC industry is desirous of having such legislation as we have before us passed at the earliest possible time. There is no way that this legislation is going to get passed at the earliest possible time with the unified opposition of Treasury and the Small Business Administration representing the views of this Administration. So, it seems to me that this is a good time to have a dialogue, and I am going to ask the same question when the industry testifies. If the industry and the Administration are in a take-it-or-leave-it posture, I don't think Senator Bumpers or I will get into that. At that stage of the game we might as well leave the field because nothing is going to happen and we are going to waste a lot of time.

On the other hand, if dialogue is going to produce a result that might be acceptable, then that is a different story. That is why I wanted to elicit these responses from you. I get a feel, Mr. Sethness, basically that the Administration is opposed to the concept, and I gather from Jim that he might have similar reservations, although he thinks we should dialogue on this subject matter. I have really no further questions under those circumstances. We will not sit here and turn it into a negotiating session now.

Senator D'Amato.

Senator D'AMATO. Mr. Chairman, I think you touch on a good point. The question is what changes, if any, will ameliorate some of the objections which the Administration has and, as Senator Weicker has indicated, there clearly are some objections which reasonable people would have to be persuaded are important and should be dealt with. And I think it goes to the question of there probably will be a bill at some point, whether it is this year or next year, that will be passed. If we can at least eliminate those legitimate areas of concern or deal with those areas of concern, well, certainly it is going to be best for the process.

So I commend the Chairman's approach in moving forward in this manner and those of the Administrator and of Treasury who have indicated a willingness to have that kind of dialogue to reduce those differences.

Indeed, in the course of time it may not result in the Administration's support, but certainly if we eliminate some of the ardor of their objections by dealing with some of the problems there, I think that is best for all concerned, so I commend the Chairman in his approach. I have got three other hearings to attend. It is good to see my dear friend, Jim Abdnor, and I look forward to working with you on this.

Mr. **Abdnor**. I appreciate that, Senator D'Amato. I would like to close by saying that we have a lot of problems that we can start to talk about, but there is an awful lot of risk in this for the Federal Government. You just saw what happened with the FCA chains, $7 billion in loans, and the interest that accumulated had been forgiven. It caused a lot of dissension because those who are paying the bill have cut clear back in farming trying to pay off that bill. Now their counterparts will go ahead and live a good life and all is forgiven. That could happen here. It is happening in the savings and loan right now, only those people have some security.

There is nothing in here for us to look after or try to protect for the Government and for the taxpayers of this country. We have no regulation. The IG now, the Inspector General, I don't think would have much to do with this bill at all.

At least, Mr. Chairman, there is some talk of regulation, although we don't think it is nearly strong enough, but the industry objects to that even. I mean, the House doesn't have it. Those kinds of things we just have to talk about.

Senator **Weicker**. Thank you very much, Senator D'Amato. I think basically, Jim, the problem is that the industry itself is concerned with the Government looking over its shoulder, I think it is, it being made express to me the fact that, if that is going to happen, you might as well have nothing at all. They are trying to get rid of the Government.

Mr. **Sethness**. They want to get rid of Government oversight, but they want to latch on as tightly as possible to the maximum amount of Government financial support and potentially open-ended risk. I would like that deal, too.

Senator **Weicker**. I don't disagree. I don't disagree with some of the comments you make, although I think it should be pointed out—which is what is bothersome to me, is when I see a letter from George Gould, a very fine gentleman, I know him, a nice man, and where in the letter he says, "In view of the foregoing, the Department would recommend to the President that he veto S. 1929 or any similar legislative proposal," where does that leave us? That is what bothers me about getting into a great deal of time picking apart the various aspects of the proposal or the financing involved, as you have done, even before everybody's mind is made up.

I do value the presentation that you have made, and I will try to work with you and, I may add, with the representatives of the industry. It might be good for both of you to stay in the room while they make their presentation.

I personally think COSBI is a good concept. I endorse the concept. It is a good concept. So I come from a different base than the Administration. Having said that, I am certainly going to take your expertise and comments presented today and apply them to my basic belief; I am not discounting the points that you are raising.

I am not slamming the door in your face and I don't want it slammed in mine.

All right, why don't we move to the next panel. As I say, all statements in full will be placed in the record. Also, there will be questions for response to the record. Let's move on now with you gentlemen in the room. Can you stay?

Mr. **Sethness**. Could I ask a couple of my staff to stay?

Senator **Weicker**. Of course you can. Absolutely.

We now have Mr. Donald Greene, legislative chairman, National Association of Investment Companies, and Mr. David Jones, the National Association of Small Business Investment Companies. Mr. Greene, Mr. Jones.

First of all, gentlemen, it is nice to have you here. Second, your statements in their entirety will be placed in the record. Feel free to synopsize your statements and, if there are matters that have been raised that you want to comment upon in your opening comments, then please do so.

STATEMENT OF DAVID B. JONES, CHAIRMAN, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES, WASHINGTON, DC

Mr. **Jones**. Thank you, Senator Weicker. I will start off, if I may. I am David Jones, chairman of the National Association of Small Business Investment Companies and president of InterVen Partners in Los Angeles, CA. I have our complete testimony that I would like to submit for the record. I would like to just touch on a very few highlights of that testimony. I think it is important to reiterate them here in light of the comments that we have heard just previously.

We believe the Administration's position is based on misleading assumptions, strawmen and red herrings. The Administration has overstated the Government's financial exposure under COSBI in an obvious attempt to hit a Congressional hot button. They have used smoke and mirrors to build their case and most of their conclusions are simply wrong. I would like to set the record straight by giving you the real facts.

COSBI will provide a long-term structure under which the SBIC Program will grow and expand. Enormous amounts of new capital will flow into small business. Millions of new jobs will be created and billions in new tax revenues will flow into the Treasury. That is what COSBI is here for. That is its essential purpose. It is a win/win proposition for small business, the Government, the SBIC industry, and the country.

Without COSBI, we are seriously concerned that the SBIC Program will wither and die. The Administration's direct assaults on the program have become a terminal cancer destroying the very marrow of the SBIC industry.

The Administration's attack on COSBI has three primary themes.

First, they argue that Federal support for the SBIC Program is no longer necessary and should be phased out. Second, they allege that COSBI will cost the Government billions of dollars. Third, they claim that the program would only work if SBA had regulatory control over COSBI and individual SBIC operations.

Let's make it clear that none of these charges stand up under close scrutiny.

First, the Administration argues that Federal support for the SBIC Program is no longer justified and should be totally phased out. This is the Administration's version of privatization. The fact is, rather than expanding, the industry is actually contracting as a result of the Administration's assaults on the program.

The Administration says the industry has increased its financing to small business. The fact is that increased financings have occurred despite the Administration's policies. The Administration neatly neglects to mention that the rate of growth in small business financings has dropped dramatically in the last 3 years and we are seriously concerned that the adverse policies at the agency will eventually cause a sharp reduction in small business investment.

The Administration also says the industry has not used leveraged funds authorized by the Congress. The fact is that the Administration's own actions have forced a reduction in the use of leverage.

The Administration's position on the non-use of leverage stands largely upon its head. First they implement policies deliberately designed to drive down the use of leverage, and then they use forced "reduction in demand" to justify their argument that the leverage isn't needed. It is a self-fulfilling prophecy.

Of most concern to me is the testimony we have heard earlier here about the claimed costs of COSBI to the Government ranging in the billions of dollars. That contention is a red herring and we believe it has no merit. An objective analysis of COSBI would review it like a balance sheet, both its costs and its benefits. Instead the Administration uses a misleading, static analysis. It paints a distorted picture of the so-called costs, fails to give any recognition to the industry's exposure to risk and totally disregards the enormous benefits COSBI creates.

In my mind, as I listened to this presentation, it was very much like hearing an announcer at the beginning of a race. All of these numbers are simply describing the numbers of the racers and their positions in the starting blocks but it has no meaning whatsoever in terms of how the race is run or what the overall finish will be. That is what we are interested in here, is what the eventual outcome will be.

The SBIC industry is in a first-risk position, not the Government. We have far more to risk than the Government does and far more at stake in assuring that COSBI works both financially and in full compliance with the letter and spirit of the law.

We, thus, conclude, No. 1, each individual SBIC has anywhere from $1 million to $130 million in private capital at risk before the Government has any financial exposure whatsoever. The Government's position as a guarantor, provider of a backstop, and holder of preferred stock are all subordinated to the SBIC's risk of loss. On day 1 the SBIC industry will have a total of over $1.5 billion in private capital, that is real dollars, already invested, already written in the program, at risk under COSBI.

And this capital at risk will continue to grow over time as the Government's limited exposure continues to shrink.

Third, and very importantly from my standpoint, industry executives also expose themselves to the very real risk of serious injury to their business reputations and character should COSBI fail. We have spent an enormous amount of time and effort constructing this program so that it will work.

We are not interested in proposing an academic exercise. We have analyzed it from every conceivable angle and are confident that COSBI as a financing source for small business will work and will achieve the public purposes we all want it to achieve.

And, finally, the industry runs the ultimate risk that the program will self-destruct if COSBI is not successful. This is our only alternative.

The Government's investment in real dollars is minimal when compared with the industry's investment and well worth the limited risk.

Let's look at the facts. The $200 million in preferred stock, it is not a giveaway; it is a good investment. It does not require an appropriation of funds. It will pay dividends as we estimate of at least $50 million and it is offset by new tax revenues of at least $40 million from COSBI itself.

And, also, it gives the Government substantial upside value through warrants which we value conservatively at $20 million immediately and may be worth many times that. The $150 million of assets and proceeds transferred to the MESBIC trust is also a good investment for the Government. It is a cost-efficient replacement for continued funding of the MESBIC Program on a direct basis. Ending the direct appropriations from the MESBIC Program will save $580 million over the next 15 years at current funding levels. It does not require an appropriation of funds.

Transfer of $270 million in SBA-held MESBIC assets to the MESBIC trust is not a cost to the Government. The trust will manage those assets for the Government in accordance with prudent fiduciary standards and, when the trust terminates, the Government gets its assets back plus a return of over $1 billion.

Let's talk about the $500 million backstop. That doesn't cost the Government a dime. There is no reason to believe that it would ever be used. It is not an open-ended line of credit. COSBI can't draw down the funds unilaterally. The Secretary of the Treasury must first determine that its use is essential and then go to Congress for the money. Congress has the final say and must pass an appropriations bill before the Government funds can be used.

Let's look at the purchase of the debentures. This is also not a cost to the Government. COSBI's purchase of those assets is priced at full market value. The Government will get $378 million in cash, preferred stock worth $200 million and warrants valued at $20 million or more. There is no increase in the Government's exposure to loss.

We are confident that the Government's risk of loss will be reduced under COSBI's management of those assets.

The Administration tries to leave the impression that the Government as guarantor would have to pay off on 100 percent of its guarantee of the $700 million portfolio. Two points should be made here.

First, SBA has a historical net loss rate on SBIC debentures of 12 percent. Based on that experience, the Government's actual risk of loss would only be $74 million on loans to the SBA, not COSBI, as already put on the books.

In addition, we firmly believe COSBI will manage those assets far better than is currently being done and, as a result, the actual losses to the Government on its guarantee will be substantially less than that amount.

Second, this guaranteed portfolio continues to diminish over time as it matures, so the Government's exposure to loss is reduced to zero in a period of less than 8 years.

Here is the real point, Government benefits: COSBI will produce enormous benefits to the American economy. We have done some analyses which show that over $21 billion can be expected to be invested in small businesses through the COSBI mechanism.

Over 105,000 small growth companies will be financed. 3.2 million new jobs will be created. The Federal Government will get $540 million in new tax revenue from SBICs alone. The companies financed by SBICs will pay $5.3 billion in new Federal taxes. The employees of these small firms will pay $16.3 billion in new Federal taxes. And COSBI itself will pay over $40 million in Federal taxes.

The Government will save money. It will save $585 million by ending direct appropriations for the MESBIC Program. By ending guarantees on SBIC debentures the Government will avoid $3½ billion of contingent liabilities. The Government will save over $400 million by eliminating direct appropriations for a loss reserve on SBIC debentures guaranteed by SBA.

At the time of the purchase the Government will receive $378 million in cash, preferred stock worth $200 million and warrants worth $20 million. COSBI will pay the Government dividends of $50 million and will return $1.4 billion to the U.S. Treasury when the MESBIC trust is terminated.

In summary, COSBI will create over 3 million new jobs in the small business sector, invest $21 billion in 105,000 small companies, and return over $20 billion in new tax revenues, income, and savings to the Government.

Let's briefly talk about regulatory control. Based on the premise that the Government will have over a billion dollars invested in COSBI, the Administration claims it is entitled to retain regulatory control over both the corporation and individual SBICs. As we have noted, the industry's capital is at risk before the Government's. The Government will lose only if the industry loses first. The industry's exposure to risk will effectively force COSBI's management to exercise sound business judgment to assure the safety and soundness of COSBI as a viable financial institution.

The proposal to give SBA rulemaking authority or the ability to run the business is virtually impossible for the industry to accept.

If SBA were granted the authority to run COSBI, it would be a major disincentive to SBIC participation. No SBICs would invest in a new enterprise and COSBI would never become operational.

We believe the regulatory structure in S. 1929, absent SBA rulemaking authority, provides a comprehensive but balanced mix of statutory, Government agency, and industry responsibilities.

Mr. Chairman, in our opinion the Administration has presented a seriously misleading and distorted view of COSBI as part of its continuing effort to terminate the SBIC Program. The Administration publicly proclaimed this position on COSBI as motivated by a desire to help them protect the little guy, the small businesses of America, and we are not so sure of that.

The Administration has refused this Committee's request to undertake an objective analysis of the COSBI legislation. They have declined to propose constructive recommendations regarding the legislation. They have simply honkered down and opposed the bill. Their objective is clear, to kill the legislation and bleed the SBIC Program through attrition.

How that posture helps the little guy is beyond our comprehension. The industry, on the other hand, has worked diligently with this Committee for several years to craft legislation that would allow for the growth and expansion of the industry on a sound business basis. With your help we now have the opportunity to establish a landmark structure that will cause enormous amounts of new capital to flow into small business, and that will help the little guy.

One last comment. The SBIC industry has been for 29 years one of the most efficient, hardest working engines of job creation and economic development in the history of the U.S. economy. That engine is now tired and missing on a few cylinders. It is time to effect a major overhaul.

Let's fine-tune that engine, supercharge it, so it can do an even better job and create even more jobs and more economic development.

Thank you, Senator.

[The prepared statement of Mr. Jones follows:]

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PETER F. McNEISH
GENERAL COUNSEL
R. MICHAEL HAYNES

March 31, 1988

STATEMENT OF

David B. Jones

before the

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I am David Jones, General Partner and President of InterVen Partners in Los Angeles, California. I am also the Chairman of the National Association of Small Business Investment Companies (NASBIC), which is the national trade association for the SBIC industry.

I'm pleased to have this chance to respond to the Administration's attack on COSBI.

The Administration's position is based on misleading assumptions, straw men and red herrings. The Administration has overstated the government's financial exposure under COSBI in an obvious attempt to hit a Congressional hot button. They have used smoke and mirrors to build their case, and most of their conclusions are simply wrong.

I'd like to set the record straight by giving you the real facts.

COSBI will provide a long-term structure under which the SBIC program will grow and expand; enormous amounts of new capital will flow into small business; millions of new jobs will be created; and billions in new tax revenues will flow into the Treasury. That's COSBI's essential purpose. It's a "win-win" proposition for small business, the government, the SBIC industry and the country.

Without COSBI, we are seriously concerned that the SBIC program will wither and die. The Administration's direct assaults on the program have become a terminal cancer destroying the very marrow of the SBIC industry.

The Administration's attack on COSBI has three primary themes:

- First, they argue that Federal support for the SBIC program is no longer necessary and should be phased out.
- Second, they allege that COSBI will cost the government billions of dollars.

- Third, they claim the program would only work if SBA had regulatory control over COSBI and individual SBIC operations.

To make it clear that none of these charges stand up under close scrutiny, I would like to review each of these points in detail.

Allegation #1. Federal Support No Longer Necessary.

The Administration argues that Federal support for the SBIC program is no longer justified, and should be totally phased out. This is the Administration's version of "privatization."

The Administration points to growth in the industry and failure to use available government leverage to support their argument.

Let's compare the real facts to their clever, but what I consider misleading, use of statistics.

a. The industry has increased its private resources.

Fact - Rather than expanding, the industry is actually contracting as a result of the Administration's assaults on the program.

Aggregate private capital in the industry has grown, but this growth has been generated by internal capitalization of earnings on investments made 7-10 years ago, when the program was running smoothly.

In fact, the number of new licensees and the amount of new capital entering the industry have dropped sharply in the last three years, reaching all-time lows.

Several former SBIC executives have testified before this Committee and the House Small Business Committee that the Administration's inconsistent or arbitrary policies have driven them out of the program. I have attached as an exhibit (Exhibit A) to my testimony a letter from a highly-qualified SBIC applicant that provides a clear example of how actions by the Administration have been a continuing deterrent to the industry's growth.

b. The industry has increased its financing to small business.

Fact - Increased financings have occurred despite the Administration's policies.

Luckily for small business, a reduced number of SBICs have had sufficient liquidity to continue to make investments. The Administration neatly neglects to mention, however, that the rate of growth in small business financings has dropped dramatically in the last three years.

We are seriously concerned that SBA's adverse policies will eventually cause a sharp reduction in small business investments.

c. The industry has not used leverage funds authorized by Congress.

Fact - The Administration's actions have forced a reduction in the use of leverage.

In support of this point, I have submitted two exhibits with my testimony. The first (Exhibit B) is a litany of program disruptions over the last 8 years which have created an environment of total uncertainty for the industry, and literally forced reductions in the use of leverage. The second (Exhibit C) is a copy of correspondence which raises serious questions concerning SBA's rejection of an SBIC's recent application for leverage.

The Administration's position on the non-use of leverage stands logic on its head. First, they implement policies deliberately designed to drive down the use of leverage. Then, they use this forced "reduction in demand" to justify their argument that leverage isn't needed. The Administration has created a self-fulfilling prophecy.

Allegation #2. COSBI Will Cost Billions

The Administration claims COSBI will cost the Government billions of dollars. That contention is a red herring, and we believe it has no merit.

An objective analysis of COSBI would review it like a balance sheet - both its costs and its benefits. Instead, the Administration uses a misleading static analysis, paints a distorted picture of so-called costs, fails to give any recognition to the industry's exposure to risk, and totally disregards the enormous benefits COSBI creates.

The SBIC industry is in first-risk position, not the government.

The SBIC industry has far more at risk under COSBI than the government, and far more at stake in assuring that COSBI works both financially and in full compliance with the letter and spirit of the law. These risks include:

1. Each individual SBIC has anywhere from $1 million to $130 million in private capital at risk before the government has any financial exposure whatsoever. This SBIC capital acts as a reserve for losses which protects the government's exposure to risk. The government's position as a guarantor, provider of a backstop and holder of preferred stock are all subordinated to the SBIC's risk of loss. The industry's self-interest in protecting its own capital will automatically protect the government's subordinate-risk position.

2. On day one, the SBIC industry will have a total of over $1.5 billion in private capital (real dollars) at risk under COSBI. And, this capital at risk will continue to grow over time as the government's limited exposure continues to

shrink. As noted above, the industry's risk of losing this capital is effectively senior to the government's risk of loss.

3. Industry executives also expose themselves to the very real risk of serious injury to their business reputations and character should COSBI fail. Although not quantifiable in dollar terms, this is a major risk for the industry.

4. Finally, the industry runs the ultimate risk that the program would self-destruct if COSBI is not successful. This will be a compelling incentive to assure COSBI will be a successful, soundly managed enterprise.

The government's investment, in real dollars, is minimal when compared to the industry's investment, and well worth the limited risk.

Let's look at the facts.

1. The $200 million in preferred stock.

The preferred stock is a good investment, not a give-away.

- It does not require an appropriation of funds.
- It will pay dividends of $50 million.
- It's offset by new tax revenues of $40 million from COSBI.

- It also gives the government substantial upside value through warrants worth $20 million, or more.
- The preferred can be redeemed at full value when COSBI has generated sufficient earnings to repurchase the stock.

2. The $150 million of asset sale proceeds transferred to the MESBIC Trust.

This is also a good investment for the Government.

- It's a cost efficient replacement for continued funding of the MESBIC program on a direct basis. Ending these direct appropriations will save $580 million over the next 15 years, at current funding levels.
- It does not require an appropriation of funds.

3. Transfer of $270 million in SBA-held MESBIC assets to the MESBIC Trust.

This is not a cost to the Government.

- The Trust will manage those assets for the Government in accordance with prudent fiduciary standards.
- And, when the Trust terminates, the Government gets its assets back plus a return of over $1-billion.

4. The $500 million backstop.

The backstop doesn't cost the government a dime.

- There is no reason to believe it would ever be used.
- It is not an open-ended line of credit. COSBI can't unilaterally draw down funds.
- The Secretary of Treasury must first determine that its use is essential, and then go to Congress for the money.
- Congress has the final say - it must pass an appropriations bill before government funds can be used.

5. Purchase of the portfolio of FFB debentures.

This also is not a cost to the government.

- COSBI's purchase of those assets is priced at full market value.
- The government gets $378 million in cash, preferred stock worth $200 million, and warrants valued at $20 million or more.
- There is no increase in the government's exposure to loss. It remains exactly the same as it is today with FFB holding the debentures on a fully guaranteed basis. In fact, we are confident the government's risk of loss will be reduced under COSBI's management of those assets.

The Administration tries to leave the impression that the government, as guarantor, would have to pay off on 100% of its guarantee of the $700 million portfolio. Two points should be made here. First, SBA has a historical net loss rate on SBIC debentures of 12%. Based on that experience, the government's actual risk of loss would be only $74 million on loans the SBA (not COSBI) put on the books. In addition, we firmly believe COSBI will manage those assets far better than the government, and as a result the actual losses to the government on its guarantee will be substantially less than that amount. Second, this guaranteed portfolio continues to diminish over time as it matures, so that the government's exposure to loss is reduced to zero in a period of less than eight years.

Benefits Produced by COSBI

COSBI will produce enormous benefits to the American economy. These include new jobs, increased tax revenues, substantial budget savings, dividends and other income, and a stream of other major benefits. Based on the COSBI financial models, our projections suggest that COSBI will produce the following results over the next fifteen years:

Small Businesses Assisted

- $21 billion will be invested in small business.
- Over 105,000 small growth firms will be financed. The rate of SBIC investments in small business will more than double.

Jobs Created

- 3.2 million new jobs will be created.

New Tax Revenues

- The Federal Government will get $540 million in new tax revenue from SBICs.
- The companies financed by SBICs will pay $5.3 billion in new federal taxes.
- The employees of these small firms will pay $16.3 billion in new federal taxes.
- $40 million in new federal taxes will be paid by COSBI.

Budget Savings

- The government will save $585 million by ending direct appropriations for the MESBIC program.
- By ending guarantees on SBIC debentures, the government will avoid $3.5 billion of contingent liabilities.
- The government will save $408 million by eliminating direct appropriations for a loss reserve on SBIC debentures guaranteed by SBA.

Income From The FFB Portfolio Purchase

- The government will receive $378 million in cash, preferred stock valued at $200 million, and warrants worth $20 million or more.
- COSBI will pay the government dividends of $50 million.
- $1.4 billion will be returned to the U.S. Treasury when the MESBIC Trust is terminated.

Summary of Benefits

In total, COSBI will:

- Create 3.2 million new jobs in the small business sector,
- Invest $21 billion in 105,000 small firms,
- Return over $20 billion in new tax revenues, income and savings to the government.

Allegation #3 - The Administration Should Have Regulatory Control Over COSBI and SBICs

Based on the premise that the government will have over a billion dollars invested in COSBI, the Administration claims it is entitled to retain regulatory control over both the corporation and individual SBICs.

As noted above, the industry's capital is at risk before the government's - the government will lose only if the industry loses first. The industry's exposure to risk will effectively force COSBI's management to exercise sound business judgement to assure the safety and soundness of COSBI as a viable financial institution. This provides built-in security for the government's postion which will automatically be protected.

Moreover, the involvement of industry executives in COSBI's management will provide the essential ingredient of business discipline and several other key advantages a government agency can't replicate. For example:

1. Industry executives know their industry and have a much better understanding of how SBICs conduct business.
2. Industry executives are experts in the areas of due diligence, risk analysis and portfolio company valuation.
3. COSBI will have the capacity to establish a sophisticated "early warning" system to discover financial problems, and the resources to act on those problems much faster than the Federal government.

SBA Rulemaking Authority

As described above, the industry has far more at risk than does the government. In light of these facts, the proposal to give SBA rulemaking authority, or "the ability to run the business," is virtually impossible for the industry to accept. If SBA was granted the authority to run COSBI, it would be a major disincentive to SBIC participation; no SBICs would invest in the new enterprise; and COSBI would never become operational.

We believe the regulatory structure in S. 1929, absent SBA rulemaking authority, provides a comprehensive, but balanced, mix of statutory, government agency and industry responsibilities. The government retains strong "watchdog" powers through numerous oversight, audit and reporting requirements. These features are built into the system to assure the "public policy" objectives of the legislation are met. I have included in my testimony a five page summary which details the extensive regulatory and oversight authority of the Federal government over COSBI (Exhibit D).

Finally, because COSBI is a Congressionally chartered enterprise, Congress retains the ultimate power to intervene: to modify the charter, to increase the government's control, or to close down the operations of COSBI.

Conclusion

Mr. Chairman, in our opinion, the Administration has presented a seriously misleading and distorted view of COSBI as part of its continuing effort to terminate the SBIC program. The Administration publicly proclaims its position on COSBI is motivated by a desire to protect and help the "little guy" - the small businesses of America.

That, Mr. Chairman, is a transparent claim. The Administration has refused this Committee's request to undertake an objective analysis of the COSBI legislation. They have declined to propose constructive recommendations regarding the legislation. They have simply hunkered down and opposed the bill. Their objective is clear - to kill the legislation and bleed the SBIC program through attrition. How that posture helps the little guy is beyond our comprehension.

The industry, on the other hand, has worked diligently with this Committee for several years to craft legislation that will allow for the growth and expansion of the SBIC industry on a sound business basis. With your help, we now have the opportunity to establish a landmark structure that will cause enormous amounts of new capital to flow into small business. That will help the little guy!

Exhibit A

MVenture
A Momentum Company

J. Wayne Gaylord
President

MAR 29 1988
RECEIVED

March 21, 1988

Mr. Robert G. Lineberry
Deputy Associate Administrator for Investment
Small Business Administration
1441 L Street, N.W.
Washington, D.C. 20416

Dear Bob:

I am writing to ask your help in facilitating the approval of the license application for MCap Corp. Last year, when we made inquiries about starting another SBIC, we were told three things: 1) it is a good time to apply for a license since so many SBICs were surrendering their licenses (there were 11 for the 6 months just prior to MCap's application); 2) the process generally takes 3 to 5 months but, since most of the management were already known to SBA, it should be closer to 3 months; and 3) with the impeccable record MVenture had built over the years, SBA would surely be pleased to begin a new associated relationship.

MCorp's senior management had originally wanted this in place by December 31, but it is now approaching 6 months since the application filing with no end in sight. You probably don't know the chronology of this so let me summarize it for you; with a little amplification, it would probably make a great book:

- April, 1987 -- Due to the many requests MVenture received for turnaround financing, it was evident that a tremendous need was not being met in the venture area. MCorp in recognizing this need, as well as the opportunities available, decided to pursue this further.
- May, 1987 -- Preliminary discussions were held with our Area Chief to determine feasibility of the request and to firm up the direction this should take.
- July, 1987 -- MCorp definitely decided to pursue this opportunity and fill this financing need for small, troubled companies.

MVenture Corp
P.O. Box 662090 Dallas Texas 75266-2090 214 939-3131
Member MCorp
A Federal Licensee under the Small Business Investment Act of 1958

- August, 1987 -- The main ingredients were worked out. It also was decided that since this new venture would be investing in troubled, turnaround, riskier investments, it would not be prudent to mix these with the MVenture portfolio nor seek SBA Leverage (which is not possible anyway since MVenture is at the ceiling); if there were to be any losses, it should be our own monies and should in no way impact the ability to pay the existing leverage indebtedness of MVenture.

- September, 1987 -- MCap's formal application with the $5,000 fee was submitted to SBA with a request that we would assist in any way to speed the decision by 12/31/87. This check was deposited by SBA and cleared our account over 5 months ago.

- December, 1987 -- I received a call from SBA wanting to know if we will be seeking SBA leverage for MCap. This was clearly addressed in the application. I referred the caller to Section 7 of the application which says MCap will not seek Leverage.

- January, 1988 -- We received a reply from Mr. Werner with the following concerns:

  1) MCap must have a telephone separate from its affiliates; we went ahead and listed it with the phone company as "MCap Corp 214/290-2775." We also had the name engraved in the building's brass directory in keeping with the request that we prominently "display the name of the Licensee."

  2) The capitalization for MCap is to be one-half common and one-half preferred stock. The Articles allowed for MCap at its option to redeem the preferred at some future date if it wishes to stop dividend expense. Apparently, SBA was uncomfortable with this because it "couldn't be counted as private capital." That was not a problem; we reiterated that we were not going to apply for Leverage! But, to satisfy SBA, MCap went back to its attorneys and amended its Articles to require prior SBA approval before any Preferred Stock could be redeemed. This was acknowledged by the Secretary of the State of Texas in Austin, Texas.

  3) A typographical error needed correcting on one of the schedules; this was corrected.

  4) Even though MCap had sent in a draft of its Management Agreement with MBank, SBA wanted to see an executed copy. This was taken to the Board of both entities and formally approved. The bank agreed to provide overhead, utilities, analytical credit services, accounting, billing services, etc. for only $2,000 per month. A fantastic bargain!

5) We were advised that dividends could only be paid out of retained earnings. We were certainly aware of this. MVenture hasn't paid a dividend in its entire life even though it is eligible to pay $8,000,000.

6) We were reminded that SBA permission is required for conflicts of interest transactions. We were certainly aware of this having been an SBIC for 11 years with a clean record in this regard.

7) A different attorney (in the firm of Hughes & Luce) other than the one who worked on the Application was needed to sign the legal opinion. This was done and re-submitted as requested.

After a conference call between me, our attorney, Gary Null, John Werner and the SBA attorney, the above issues were all addressed and subsequently resolved.

- February, 1988 -- I was contacted by SBA because MCap didn't actually have the initial capital in a bank account. I explained that we didn't want several million dollars idly sitting there during the approval process, so we had the Boards of the various MBanks pass a resolution saying they would put $45 million into the company as needed. SBA told me this wasn't good enough; the account had to be opened and a "no restrictions" letter sent to SBA. I called on MBank Dallas first. It put $~~2,500,000~~ into the account and the no-restrictions letter was signed by the bank's Chief Financial Officer, Mr. Hashaway. I had it couriered to SBA. A few days later SBA informed me that they couldn't accept the certification of the Chief Financial Officer of MBank because he was also a proposed officer of MCap. I had another "no restrictions" letter signed by another officer of the bank and had it couriered to SBA.

- March, 1988 -- The Board of MCap asked me to determine the delay in processing this application. I called SBA and was told everything was proceeding on schedule; in fact, because of the impeccable record of MVenture, the usually required pre-licensing face to face meeting would not be necessary.

- March, 1988 -- SBA contacted me again this week. The question has been raised, "Why does MCorp need another SBIC?" I couldn't believe my ears, especially in the light of *all* the events that have transpired during the application phase! This question should have been raised last summer; in fact it *was* and I felt it was thoroughly discussed by phone and covered in *Section 6* of the application.

Notwithstanding the previously submitted information, I will again detail MCorp's need for another SBIC.

MCap Corp will make investments primarily in the Southwest region of the United States, and, predominately, in Texas. Texas enjoyed sustained growth through the 1970's and into the 1980's. During the period July 1, 1980 to July 1, 1984, total population increased from 14,320,800 to 15,988,500, an increase of nearly 12%, or three times that of the National average (*Texas Business Review*, Feb. '87).

Because of an economic downturn in the energy industry, Texas is not expected to sustain this accelerated growth rate,however, because of extensive diversification efforts, the State is expected to grow in the next decade at slightly above the national average.

Texas and its surrounding states have long been dependent upon the production and sale of crude oil. This is changing. For example, the Dallas area added more manufacturing jobs in 1986 than the Boston area has added in the last 12 years. Texas ranks third in the nation in the number of people employed (7.5 million), only 440,000 behind New York. This gap was narrowed in 1987. The fast growing sectors of employment industry (including hotels, repair businesses, amusements, health, education and other services) also made a strong showing.

Most cities throughout Texas have established Economic Development Councils and are working together to bring more industry to Texas.

Two major projects which are considering sites in Texas are the Super Collider and the National Center for Manufacturing Sciences. These two projects alone could bring thousands of new jobs to Texas in the next few years. The recent announcement of J.C. Penney to relocate its national headquarters to the Dallas area reflects the strong commitment to retailing that is found in this region.

Small business: According to the latest figures released by the U.S. Bureau of Census, there are 958,000 small businesses in Texas, with 81,000 located in or near the Dallas/Ft. Worth Metroplex. This number continues to grow steadily each year according to the local office of the SBA.

Number of SBICs: There are about a dozen SBICs in the Dallas area, but only 8 or 9 are active; as far as can be determined, none have targeted the same markets as MCap Corp. In fact, MVenture contacted over a dozen of the active SBICs in this area and not a single one was interested in investing in troubled, turnaround situations. (Documentation for this is held in our files).

Availability: It is common knowledge that most traditional financing sources in the Southwest (banks and savings & loans) have sustained substantial losses during the last two years. Much of this related to the depressed energy and real estate markets; nevertheless it has had a restrictive effect on all segments of the economy. As traditional money sources have become more conservative in the face of recent operating losses, much needed capital for new enterprises, as well as for existing under-capitalized businesses, has become extremely scarce.

MCap Corp intends to invest its funds in troubled, turn-around situations which are typically under-capitalized but possess the inherent ingredients for a future successful company. These firms will be from a variety of industries since these situations will be found in virtually every sector of the economy. We strongly feel that many companies in these situations are only 24 to 36 months away from restoring substantial profitability and viability. MCap Corp seeks to benefit from this turnaround. And, coincidentally, the SBIC minimum period of financing (5 years) generally coincides perfectly with the investment exit plans of MCap Corp.

MCap Corp sees no current investor on the scene willing to assume these risks and assist these small companies at this critical time when bankruptcies are at an all-time high. MVenture's recent survey of Texas SBICs bears this out. Additionally, we have been told on good authority that the largest bank owned SBIC in Dallas (other than MVenture of course) will not be doing new deals of any kind for the foreseeable future. MCap Corp believes that the time is ripe to render such assistance in the small business community.

One might ask why this can't be done in the existing SBIC. The answers are numerous and very logical:

- The key people driving MCap (Hudgins and McPherson) are not officers of MVenture and have no part in it.

- The proposed stockholders of MCap , though affiliated, are completely different from those of MVenture. In other words, the $20 million in unrealized appreciation belongs to MBank Dallas, not MBank El Paso, MBank Corpus Christi, etc. This might not be meaningful to an outsider, but it is just as important to us as it would be to you if suddenly SBA had to share all of its profits with the Justice Department. Someone might say, "What difference does it make? It's all the government anyway."

- The philosophies are different: MVenture invests in mature, healthy, profitable companies. MCap will invest in good opportunities but typically turnaround situations that may not currently have profitable trends. I don't want my MVenture Investment Officers working along side the turnaround Investment Officers. The MVenture officers have a clear picture of what is expected. I don't want to confuse this philosophy which has been so successful. It's two different approaches and it just wouldn't benefit either company.

- Since there is a stronger element of risk in turnaround situations, I think it should be our own monies at stake and not in any way dilute the MVenture portfolio or put the $35 million SBA Debentures at risk. By having two distinct SBICs, the SBA Debentures are thoroughly protected. This is not to say that we don't think MCap will be successful. We do, but from a practical standpoint, the two separate entities protect SBA interests more effectively. Incidentally, MVenture's year-end #468 report will reflect some $20,000,000 in unrealized net appreciation in investments.

MVenture has brought the highest standards to the SBIC program. In eleven years it has:

1) risen to one of the largest and most respected in the country;

2) has never paid a penny in dividends but left millions in Retained Earnings and capitalized millions more;

3) has had a profitable record in each of its eleven years;

4) always fulfilled its promises and obligations to the SBA;

5) always upheld the high standards of the SBIC program;

6) experienced unusually clean examination reports over the years;

7) worked diligently with SBA and Congress to preserve the SBA during the time that the Administration was trying to dismantle it.

8) participated in public hearings when requested by SBA;

9) at the request of SBA, personally conducted a number of seminars for financiers, small businessmen, bankers, and other SBA personnel on the merits of the SBIC program;

10) assisted scores of small businesses in achieving their financial goals.

We know we enjoy a good rapport with SBA because of the dozens of referrals I get each month from the local, regional and national offices of SBA, from investment possibilities to regulatory questions. It's not uncommon for SBA to refer a new applicant to me for first hand experience on how the program works. We have always handled these with pride as we have great respect for the purposes of the program. I was told yesterday by the manager of a Louisiana SBIC that the SBA Field Examiner told him, "MVenture is the best managed SBIC in my region." Now I am confused by the delay we are experiencing and are hoping the information printed in the latest NASBIC Newsletter is erroneous: "Three former SBIC executives each told (the House) a compelling story of how SBA's inconsistent management and arbitrary policy actions had driven them from the program or completely cooled their interest in forming a new SBIC." Until now, this has not been our experience.

We strongly believe that MCap is justified on all fronts: to MCorp who is willing to take these risks; to the SBA who without risking leverage can expect another successfully run SBIC; to the small businesses who are desperately seeking this help.

If necessary, I or any of the MCap Board can be on a plane to Washington within 24 hours to meet with you. I repeat that we will provide SBA with any additional information it needs to bring this to a favorable conclusion, but respectfully submit that all the ingredients are already there. We simply need your approval to proceed.

Sincerely,

J. Wayne Gaylord

J. Wayne Gaylord

JWG/lb

010/075

Exhibit 8

Litany of Program Disruptions and Mid-Stream Policy Changes

1981 Cardenas	Moratorium on licensing (4/17-7/17) No leverage for five months (April to Aug.) Local review of "need" made a new licensing requirement (a veiled effort to blackball license applicants for political reasons) Attempt to abolish direct funding for MESBICs $1-million cap on leverage applications New leverage requirements imposed Cardenes threatens new moratoriums "at any time"
1982 Cardenas/ Sanders	Wholesale rewrite of regulations proposed - industry begins 2-year struggle against mindless regulatory proposals On-going fight over size standards Unnecessary complexity added to licensing process Administration trys to cut leverage from $160 to $125-million Change in Administrators (March)
1983 Sanders	Crackdown on equity SBICs (Kalbach forced out/ side agreements imposed on others) Attempt to impose "balanced portfolio" standard on the industry No leverage available in May or June 41 SBICs apply for $113-million in July - only $19-million available No leverage available in August Allocation restrictions imposed on leverage Commercial bank criteria imposed on borrowing Threat to force investments in specific industries Rewrite of regulations effective (9/30), ending two-year period of stress and controversy
1984 Sanders	New accounting requirements proposed (2/29) New 1.18% users' fee imposed (4/27) - no offsetting increase in allowed charges - squeeze on margins New investment diversification rule proposed (11/1) - no more than one-third of an SBIC's investments in any one industry category Allocations of leverage continue Application of bank lending criteria continues
1985 Sanders	Administration moves to abolish SBA and end all financial assistance programs Battle to save SBA rages through the year Allocation restrictions on leverage continue Application of bank lending criteria continues

1986 Heatherly	Sanders leaves (January) Administration renews attempt to abolish SBA Leverage through FFB funding system terminated (last FFB funding 3/17) Heatherly named Acting Administrator (4/1) - he promptly announces support to end all financial assistance programs Reconciliation Act containing new private market funding system signed into law (4/7) SBA attempts to scuttle new leverage system March-September - 6 month leverage drought - great uncertainty in industry September 23 - first funding under new system OMB objects to new funding system - December funding delayed until February, 1987 Allocation restrictions on leverage continue Application of bank lending criteria continues
1987 Heatherly/ Abdnor	Administration proposes reduction in SBIC leverage, 50% cut in MESBIC funding, termination of MESBIC preferred stock, reducing the guarantee to 90% and an additional user fee New Administrator sworn in (3/23) SBA proposes 60% increase in exam fee (8/24) SBA cracks down on industry-specialized SBICs Funding process sporadic Allocation restrictions on leverage continue Application of bank lending criteria continues
1988 Abdnor	SBA begins to second guess SBIC Board valuations of SBIC investments SBA begins to second guess investment plans of SBICs SBA institutes new formula based limit on SBIC and MESBIC expenses SBA announces another proposed major overhaul of the regulations SBA staffing cut - responsiveness deteriorates 3 Area Chiefs now responsible for an average of 154 companies, plus license and funding applications Funding process continues to be sporadic Allocation restrictions on leverage continue Application of bank lending criteria continues Administration proposes reduction of SBIC funding level to $150 million (a 36% cut) Administration proposes elimination of all subsidies for MESBICs - tantamount to destruction of the MESBIC program

Exhibit C

BRITTANY CAPITAL COMPANY
2424 LTV Tower
1525 Elm Street
Dallas, Texas 75201
A/C (214) 954-1515

February 24, 1988

Ms. Patricia L. DiMuzio, Chief, Area III
Office of Investment
U.S. Small Business Administration
1441 L Street NW
Washington, DC 20416

RE: License No. 06/10-0152

Dear Ms. DiMuzio:

Needless to say, I am shocked over SBA's decision to decline our Application For Guaranty. I presume that SBA has changed its credit policy without prior notification.

I would like to respond point-by-point to the issues raised in your letter dated February 17, 1988 concerning Brittany Capital Company's current financial status and its ability to service its outstanding debt. Let me preface my responses by stating that Brittany has always been an equity oriented investor (as is required to obtain a fourth tier of leverage), consequently we have few loans outstanding and hence few current maturities. In addition, our earnings stream is often characterized by several years of operating losses followed by large capital gains as would be expected from our investment policy. I feel that this policy follows closely the intent of the SBIC program by encouraging small businesses to grow without the constraining burden of debt service.

You point out that Brittany had a negligible amount of idle funds. It seems obvious to me that had we had funds we would not have made application for additional leverage, and in fact, if we had any significant degree of idle funds we would have been ineligible for leverage. Since year end, our partners have injected $125,000 in cash into Brittany so that it may service its debt on a current basis. It is the partners desire to maintain their $750,000 in equity in this partnership and seek capital appreciation of its portfolio and not become a "spread lender". It appears to me that by this change of policy regarding leverage eligibility SBA is now discouraging long term equity investing. This is contradictory to the spirit of the SBIC program. Brittany has many young companies that are becomming valuable. The gains from a prudent sale of these investments should satisy any debt service requirements.

Ms. Patricia L. DiMuzio
February 24, 1988
Page 2 of 2

Because of the reasons stated above, we have years where we have little or no current income and 1987 happened to be one of those years. Our operating expenses were fairly normal for the year. Certainly the interest on our debentures and our salaries were exactly as could have been predicted. This makes up 75% of our operating expense and was approved by SBA.

You state in your letter that you do not wish Brittany to be in the position of having to sell its portfolio investments to meet its financial obligation. It is a central theme of the SBIC program that SBA guaranteed debt is repaid from the sale of portfolio assets. Now Brittany, because of SBA actions, must sell some of its portfolio items at a significant discount in a forced liquidation to maintain operating capital and satisfy its existing obligations.

It appears Brittany and other SBIC's are now expected to satisfy commercial loan standards. This is the first time in the ten years that Brittany has been owned by its current partners that Brittany has been declined additional leverage on a "uncredit worthy" basis. I would like to point out that when the Brittany partners purchased Brittany it was severely capital impaired. Since that date, they have doubled the private capital in the portfolio and attempted to operate this SBIC in the spirit of the program. We were given no indication of this credit problem when we made application for leverage in August, 1987 and in fact were told that we had resolved the problem that prevented guaranty at that time.

Now that there is a new credit policy at SBA, I would appreciate you sending me the guidelines under which we must perform in order to obtain new leverage.

Thank you for your prompt attention to this matter.

Sincerely,

BRITTANY CAPITAL COMPANY

Steven S. Peden
General Partner

SSP:meb

BCC: Mr. Peter F. McNeish, President
NASBIC

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

License No. 06/10-0152

FEB 17 1988

Mr. Steven S. Peden
General Partner
Brittany Capital Company
2424 LTV Tower
1525 Elm Street
Dallas, Texas 75201

Dear Mr. Peden:

This is to inform you that your recent application for guaranty in the amount of $500,000 has been declined by this Agency because of the Licensee's apparent inability to service its current SBA debt, let alone take on new debt service.

The amount of your idle funds at December 31, 1987, was negligible; you list no "current maturities" for loans; your operating expenses are too high, in our opinion, relative to your annual revenues; and we do not want your company to be in the position of having to sell off portfolio items to meet its financial and/or operating obligations.

We trust you understand our position in this matter.

Sincerely,

Patricia W. Di Muzio

Patricia W. DiMuzio
Chief, Area III
Office of Investment

Exhibit D

Regulation and Oversight of the SBIC Program Under COSBI

A. Licensing

1. Basic Standards Codified - The basic qualification standards for licensing are codified in the statute. To qualify, an SBIC must have:

a. a minimum private capital of $1 million,

b. owners and managers with sound business reputations and character, and

c. the probability of successful operations, including adequate profitability and financial soundness.

2. Additional Qualification Requirements - The statute also directs COSBI to establish such additional qualification criteria for an SBIC to do business with the corporation as may be appropriate. These criteria will be subject to SBA and Congressional review.

B. Regulation of SBIC Business Practices

1. Regulations Codified - The major regulatory restrictions on SBIC business practices are clearly enumerated in the statute. These include:

a. Prohibition against conflict of interest transactions,

b. Restriction of investments to only qualified small business,

(Note - the size standard itself is codified in the statute),

c. Prohibition against control of small firms,

d. Required diversification of investment risk, i.e., an SBIC can invest no more than a 20% of its private capital in any one small business,

e. Prohibition against investments in passive businesses, foreign companies, re-lending activities, or the acquisition of real estate, and

f. Prohibition against engaging in unlawful or non-SBIC activities (i.e., operating other types of businesses).

2. Public Board Members' Approval of Major Rules - The major rules adopted by COSBI to implement the statutory restrictions governing the operations of SBICs (i.e., those codified in the statute) require the approval of not less than 3 of the 5 Board members appointed by the President and confirmed by the Senate.

3. Approval of Non-Major Rules - COSBI's rules governing the ordinary aspects of SBIC operations require the approval of a majority of COSBI's Board of Directors.

4. Conduct Governed by Contract - SBICs are required to enter into a contract with COSBI, under which they agree to abide by COSBI's rules governing SBIC business practices. The rules noted above and the enforcement provisions noted below will be incorporated into these contracts.

C. Oversight, Audits and Investigations of SBIC Business Practices

1. COSBI Audits and Investigations - The statute mandates that COSBI exercise due diligence in the oversight, auditing and investigation of SBIC business practices. COSBI will have its own expert staff to carry out these functions, supplemented by independent CPA audits of each SBIC. In addition, a special Regulatory Compliance Committee of the Board of Directors will provide policy direction and oversight for these activiites.

2. Biannual Compliance Audit of SBICs - The statute requires a biannual compliance audit of each SBIC by an independent CPA or by COSBI.

3. SBA Oversight - SBA has review authority over all of COSBI's operations, including qualification of SBICs to do business with COSBI, rules or regulations governing the operations of SBICs and "such other matters as the Administrator deems appropriate."

4. SBA Access to Books and Records - SBA has access to all of COSBI's books and records, including all financial and compliance audits of individual SBICs.

5. COSBI Reports to SBA - SBA is given specific authority to require COSBI "to make such reports as the Administration deems desirable."

6. SBA Annual Report to Congress - SBA must prepare an annual report for the Congress and the President on COSBI's operations and activities.

7. SBA Inspector General Access to Books and Records - The Inspector General of SBA has access to all COSBI records, including all financial and compliance audits of SBICs.

8. SBA Inspector General Investigations of SBIC Business Practices - The Inspector General of SBA is authorized to investigate an individual SBIC which has an outstanding SBA-guaranteed debenture, where it can be shown that probable cause exists to believe that an SBIC has committed civil fraud or has violated a federal criminal statute. The IG is empowered to establish probable cause standards.

9. GAO Access to Books and Records - GAO, as Congress' agent, has access to all of COSBI's books and records, including all financial and compliance audits of SBICs.

10. GAO Report to Congress - GAO is required to submit a report to Congress by January 31, 1991, on how well COSBI has achieved the purposes of the Act. Presumably, this will include an assessment of SBIC business practices.

11. Committee Oversight - The statute specifies that the Small Business Committees of Congress have access to all of COSBI's books and records, including all reports to COSBI from SBICs and audits of SBICs.

D. Enforcement of SBIC Compliance

1. Civil Enforcement Powers - COSBI will have access to all appropriate civil remedies where an SBIC has breached its contractual agreement with COSBI, including acceleration of debt in cases of default, actions to enforce contractual conenants and initiation of litigation against the SBIC.

2. Statutory Enforcement Powers - The statute directs COSBI to adopt measures to assure compliance with its rules and regulations, and provides COSBI with several specific enforcement powers, including:

a. Termination or suspension of agreements between COSBI and an SBIC,

b. Termination of an SBIC's qualification to do business with COSBI,

c. Assessment of penalties against an SBIC or its officers or directors,

d. Removal or suspension of officers or directors, or

e. In appropiate cases, referral of violations to SBA for investigation, or referral to the U.S. attorney.

3. IG Action on Investigations - In those cases where the IG's investigations result in findings of civil fraud or criminal violations, the IG could would make appropriate referrals for litigation or prosecution.

E. Oversight and Review of COSBI's Regulatory Performance

1. SBA Oversight - SBA has review authority over all of COSBI's operations, including the standards it sets for SBICs to do business with COSBI, the rules or regulations it establishes for SBIC business practices and "such other matters as the Administration deems appropriate."

2. SBA Access to Books and Records - SBA has access to all of COSBI's books and records, including those relating to regulatory activities.

3. COSBI Reports to SBA - SBA is given specific authority to require COSBI "to make such reports the Administration deems desirable," including reports on any regulatory actions.

4. SBA Annual Report to Congress - SBA must prepare an annual report for the Congress and the President on COSBI's operations. This report will include an assessment of COSBI's regulatory activities.

5. SBA Inspector General Access to Books and Records - The Inspector General of SBA has access to all of COSBI's books and records, including all materials relating to regulatory activities.

6. GAO Review - The Small Business Committees have specific authority to direct GAO to review any aspect of COSBI's regulatory operations at any time, and GAO has full authority to review COSBI's regulatory operations.

7. GAO Audit - COSBI is subject to a GAO audit of its regulatory actions at any time at the request of either Small Business Committee of Congress.

8. GAO Report to Congress - GAO is required to submit a report to Congress by January 31, 1991, on how well COSBI has achieved the purposes of the Act. This will include an assessment of COSBI's regulatory performance.

9. Committee Oversight The Small Business Committees have full, ongoing legislative oversight of COSBI's operations, including access to all of COSBI's books and records relating to regulatory activities.

F. Oversight and Review of COSBI's Financial Performance

1. Restriction on COSBI Debt - The statute specifically restricts COSBI from incurring excessive debt by setting a maximum debt to capital ratio of not more than 15 to 1, which is the same as the statutory FNMA debt restriction.

2. Treasury Approval of COSBI's Issuance of Securities - All obligations issued by COSBI must be approved by the Secretary of the Treasury. This conforms with Treasury's authority to control the issuance of securities by other GSEs.

3. Annual Financial Audit of COSBI - The statute requires that COSBI be audited each year by an independent CPA or Treasury.

4. Treasury Access to Books and Records - Treasury has access to all of COSBI's financial books and records.

5. Treasury Financial Report on COSBI - The statute requires that Treasury provide Congress and the President with an annual audit report on COSBI, with information on the corporation's operations and financial condition, and any appropriate recommendations.

6. SBA Access to Books and Records - SBA has access to all of COSBI's financial books and records.

7. SBA Inspector General Access to Books and Records - The Inspector General of SBA has access to all of COSBI's financial books and records.

8. Committee Access to Books and Records - The Small-Business Committees have access to all of COSBI's financial books and records.

9. GAO Access to Books and Records - The GAO has access to all of COSBI's financial books and records.

10. GAO Audit - COSBI is subject to a financial audit by GAO at any time at the request of either Small Business Committee.

11. GAO Report to Congress - GAO is required to submit a report to Congress by January 31, 1991, on how well COSBI has achieved the purposes of the Act. This will include an assessment of COSBI's financial performance.

1986 Heatherly	Sanders leaves (January) Administration renews attempt to abolish SBA Leverage through FFB funding system terminated (last FFB funding 3/17) Heatherly named Acting Administrator (4/1) - he promptly announces support to end all financial assistance programs Reconciliation Act containing new private market funding system signed into law (4/7) SBA attempts to scuttle new leverage system March-September - 6 month leverage drought - great uncertainty in industry September 23 - first funding under new system OMB objects to new funding system - December funding delayed until February, 1987 Allocation restrictions on leverage continue Application of bank lending criteria continues
1987 Heatherly/ Abdnor	Administration proposes reduction in SBIC leverage, 50% cut in MESBIC funding, termination of MESBIC preferred stock, reducing the guarantee to 90% and an additional user fee New Administrator sworn in (3/23) SBA proposes 60% increase in exam fee (8/24) SBA cracks down on industry-specialized SBICs Funding process sporadic Allocation restrictions on leverage continue Application of bank lending criteria continues
1988 Abdnor	SBA begins to second guess SBIC Board valuations of SBIC investments SBA begins to second guess investment plans of SBICs SBA institutes new formula based limit on SBIC and MESBIC expenses SBA announces another proposed major overhaul of the regulations SBA staffing cut - responsiveness deteriorates 3 Area Chiefs now responsible for an average of 154 companies, plus license and funding applications Funding process continues to be sporadic Allocation restrictions on leverage continue Application of bank lending criteria continues Administration proposes reduction of SBIC funding level to $150 million (a 36% cut) Administration proposes elimination of all subsidies for MESBICs - tantamount to destruction of the MESBIC program

STATEMENT OF DONALD F. GREENE, PRESIDENT, MINORITY EQUITY CAPITAL COMPANY, INC., AND LEGISLATIVE CHAIRMAN, NATIONAL ASSOCIATION OF INVESTMENT COMPANIES, ACCOMPANIED BY DIANE THOMAS, VICE PRESIDENT, NATIONAL ASSOCIATION OF INVESTMENT COMPANIES

Mr. GREENE. Good morning, Senator Weicker, and members of the Small Business staff. We have filed our testimony for the record and I would like to extract from that testimony as quickly as I can.

My name is Donald Greene. I am accompanied by Ms. Diane Thomas, who is vice president of the National Association of Investment Companies. I am president of Minority Equity Capital Company, which is a New York based MESBIC, and I also have the honor to serve as the legislative chairman for the National Association of Investment Companies, which is the trade association representing the MESBIC industry.

I am pleased to be here today to offer some general comments with respect to the Administration's objectives, their current proposals to create COSBI, specifically as they relate to the MESBIC industry.

Several of my colleagues, including Ms. Joann Price, who is chairman of our trade association, have appeared before this Committee recently and also on the House Small Business Committee to testify in support of S. 1929 and H.R. 3392.

I think that collectively we have been able to demonstrate the importance of the Government's role in the program partnership, which created MESBICs effective 1972. The availability of the Government funds, matching Government funds and special incentives for MESBICs have attracted over $172 million in private sector capital into this industry through 1987.

Although through the years we have been able to demonstrate the success of the MESBIC Pogram, there are now factors inherent in our current funding and regulatory structure that have brought us to the point where many of us believe our industry is facing great difficulty, if not outright extinction. These signs might include the reduction we are now experiencing in our private capital investments this past year. For the first time we had a net 3 percent decline in private capital.

There is a reduction in the number of licensees. In 1985 we had 146 MESBIC licensees and today we have 128.

Last year we lost three licenses for every new licensee that came into the industry, and we have continued to face real funding shortages in terms of our leverage availability.

Over and above all of that, we are particularly concerned about the rather vicious attacks that the Administration has launched against the MESBIC industry. Even though they have been unable to eliminate the industry by cutting off our funding, which has been attempted on a number of occasions, the capricious and arbitrary interpretation of regulations can in effect almost serve the same purpose and be our death knell.

We are trying to run venture capital businesses and we need a positive, a constructive relationship with the SBA, which is evidently not to be.

As someone who has dealt personally with the funding and regulatory instability of the SBA for a number of years, I could not help but sense a basic negative view in the SBA toward the process of capital formation.

Apparently people at the SBA view the MESBIC industry as a recipient of special advantages inconsistent with the realities of the marketplace that we serve and are uncomfortable with the fact that we have become profitable despite these handicaps.

More than ever before the MESBIC industry needs COSBI if we are to continue to be vital and grow. In making the kind of business decisions that we have to make, these involve long-term decisions, and that is getting increasingly difficult given that we don't know there is even a future here with the current posture of the SBA.

Even with the good intentions of this Committee and our other friends in Congress we have not been able to save ourselves from arbitrary policy changes and rather severe budget cuts. Our leveraged financing was $45 or $46 million just a few years ago. It is now down to $36 million and has been zeroed out.

We have given COSBI a great deal of thought and concern and we have put a lot of work into it. When the concept was first designed, we had to ask ourselves a lot of tough questions that included concern with whether or not the MESBICs would be protected as small players, whether we continued to set up a system to provide special incentives to the MESBICs, whether we would have equal access to the funding windows, whether pricing of COSBI securities would be at a kind of pricing that was equitable for us, would we get adequate representation in its leadership and whether COSBI could continue to recognize the special mission of the MESBIC industry?

We answered those questions in the affirmative and we signed on.

I would like to address briefly some of the Administration's concerns, beginning with the Small Business Administration.

It is their view that the SBIC and MESBIC Programs have progressed to a point where their graduation to the private sector is called for, and we would like to point out that the number of investments our industry has been able to make are declining.

Specifically from 1986 to 1987 we declined a couple of million dollars and a number of investments. We also want to point out that in recent years our ability to attract private capital to the industry has also declined. In the numbers that they cite, they fail to point out that most of that growth occurred between 1981 and 1983, and in the last 4 years it has flattened out substantially and, indeed, we had a net drop in private capital over the last year.

The SBA indicates, acknowledges, that we have had backlogs in our requests for leverage, but they indicate that we are making leverage applications strictly for the subsidy benefits, and that is part and parcel of this hostile attitude that we find in this partnership with the SBA, which has deteriorated.

I would like to make just a couple of comments about Mr. Gould's comments from the Treasury Department. First he indicates that there is little incentive for COSBI to scrutinize the credit worthiness of MESBICs. It is incomprehensible that if the trust dies, the MESBIC trust dies that we die along with it, and we would not be able to generate an increase in private capital.

Whenever the trust administration evaluates a leverage request from a MESBIC, they, in effect, would be viewing or evaluating the credit worthiness of that MESBIC. If COSBI attempted to issue separate securities solely for MESBICs, pricing would be impractical for our industry and, in addition, the trustees in management of the trust have a fiduciary responsibility.

Mr. Gould also criticizes the MESBIC portfolio as a multi-billion-dollar giveaway. Again, it is in our own self-interest to maintain a healthy and viable trust, and as evidence of this we have proposed even greater restrictions on leverage than currently used by the SBA to ensure the fiscal strength of the trust. These provisions include such things as a mandatory call on preferred stock, which is not now in place.

In addition to that, the Federal Government receives compensation for the transfer because clearly we feel that budget appropriations will be made available to MESBICs going forward and those are not now going to be made with COSBI in place, and we think that in just 7 years the Federal Government will save more than the value of the assets transferred to the trusts.

Again, the transfer to the trust is not a giveaway; it is a transfer, and securities are being managed for the Federal Government.

Mr. Gould's comments demonstrate a lack of understanding of our industry and he is evidently very unfamiliar with our operations.

To wind this down, I want to make a couple of comments about the capital structure. The initial capitalization of COSBI will come from SBICs and MESBICs. MESBICs which have a lower capitalization level and a higher leverage level will be purchasing stock reflecting 1 percent of its private capital and either 1 percent of their preferred stock or debenture leverage. This provision will ensure that the MESBICs will not pay an unreasonably high percentage of their assets for COSBI participation.

The board of directors of COSBI will consist of 15 persons, nine of those elected by the membership and five appointed by the President, and MESBICs will have not less than one representative on that board.

This mandatory board representation for a MESBIC representative is absolutely essential in the industry's support of the bill.

There is one change that we would like to see in S. 1929. We would prefer to see any possibility of direct regulation of MESBICs and SBICs by the SBA eliminated. With respect to MESBICs, the SBA has proven to be a progressively hostile partner and we just don't need them and their policies regulating us directly.

In conclusion, Senator Weicker, we know that you and Chairman Bumpers, and the other Members of this Committee, have been very good friends to the MESBIC industry. We know that you support our goal of developing the minority business community. We are here today, I am here today to make sure that you have heard our warnings about the serious repercussions to the SBA's actions with respect to our industry. We are losing our licensees. We are losing our ability to attract private capital in the long-term small business community. The minority small business community is going to lose access to what I believe is the only organized source of venture capital in this country.

We think COSBI is the vehicle to restore our vitality, put MESBICs back in a growth pattern and, moreover, will serve the long-term interest of the Federal Government, as Mr. Jones has made available with his statistics. It is an appropriate graduation for us. It is a win/win situation.

Thank you for this opportunity to discuss the MESBIC position with respect to COSBI and I will be prepared to answer any questions.

[The prepared statement of Mr. Greene follows:]

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TESTIMONY

BY

DONALD F. GREENE

PRESIDENT

OF

MINORITY EQUITY CAPITAL COMPANY, INC.

BEFORE THE

SENATE SMALL BUSINESS COMMITTEE

MARCH 31, 1988

Vice Chairman
DONALD F. GREENE
Minority Equity Capital Company, Inc.
New York, New York

Secretary
RALPH L. McNEAL, SR.
North Street Capital Corporation
White Plains, New York

Treasurer
ALVIN MURSTEIN
Medallion Funding Corporation
New York, New York

Directors
L. JIM BARRERA
Triad Capital Corporation of New York
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OSCAR FIGUEROA
Rutgers Minority Investment Company
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JAMES KOBUS
Motor Enterprises, Inc.
Detroit, Michigan

J. PETER THOMPSON
Opportunity Capital Corporation
San Francisco, California

JAMES S. YU
Intercontinental Capital Funding Corporation
New York, New York

GOOD MORNING SENATOR WEICKER AND MEMBERS OF THE SENATE SMALL BUSINESS COMMITTEE. I AM DONALD F. GREENE, PRESIDENT OF MINORITY EQUITY CAPITAL COMPANY, (MECCO), A NEW YORK-BASED MESBIC, AND LEGISLATIVE CHAIRMAN OF THE NATIONAL ASSOCIATION OF INVESTMENT COMPANIES (NAIC), THE OFFICIAL TRADE ASSOCIATION REPRESENTING THE MESBIC INDUSTRY. I AM HAPPY TO BE HERE TODAY TO OFFER A RESPONSE TO THE ADMINISTRATION'S OBJECTIONS TO THE CURRENT PROPOSALS CREATING THE CORPORATION FOR SMALL BUSINESS INVESTMENT (COSBI).

MY COLLEAGUES AND I HAVE APPEARED BEFORE THIS COMMITTEE AND THE HOUSE SMALL BUSINESS COMMITTEE SUBCOMMITTEE ON SBA AND THE GENERAL ECONOMY ON SEVERAL OCCASIONS OVER THE PAST SEVERAL MONTHS TO PRESENT TESTIMONY IN SUPPORT OF S. 1929 AND H.R. 3392, THE SENATE AND HOUSE VERSIONS OF THE LEGISLATION TO CREATE COSBI. WE HAVE DEMONSTRATED THE IMPORTANCE OF THE MESBIC INDUSTRY TO THE MINORITY SMALL BUSINESS COMMUNITY. JUST LAST WEEK NAIC PRESIDENT JOANN PRICE APPEARED BEFORE THIS COMMITTEE DURING BUDGET HEARINGS AND EXPLAINED THAT FOR EVERY DOLLAR A MESBIC INVESTS IN A MINORITY OWNED SMALL BUSINESS, OTHER PRIVATE SECTOR INVESTORS WILL INVEST TWO DOLLARS, BUT ONLY AFTER WE HAVE TAKEN THE POSITION OF FIRST RISK. WE HAVE ALSO DEMONSTRATED THE IMPORTANCE OF THE GOVERNMENT'S ROLE IN THE PROGRAM PARTNERSHIP. THE AVAILABILITY OF MATCHING GOVERNMENT FUNDS ON SPECIAL TERMS FOR MESBICS HAD ATTRACTED OVER $172 MILLION OF PRIVATE SECTOR INVESTMENTS TO THE INDUSTRY BY THE END OF 1987.

ALTHOUGH WE HAVE DEMONSTRATED THE SUCCESS OF THE MESBIC PROGRAM, WE ALSO HAVE SHOWN HOW FACTORS INHERENT IN OUR CURRENT

FUNDING AND REGULATORY STRUCTURE HAVE BROUGHT US TO THE POINT WHERE MANY BELIEVE OUR INDUSTRY IS FACING EXTINCTION. THE SIGNS OF OUR DEMISE INCLUDE:

1. IN 1987, FOR THE FIRST TIME IN THE MESBIC INDUSTRY'S HISTORY, WE EXPERIENCED A REDUCTION IN THE LEVEL OF OUR PRIVATE CAPITAL INVESTMENTS. THIS IS DIRECTLY ATTRIBUTABLE TO THE UNCERTAINTY OF THE PROGRAM'S MATCHING GOVERNMENT FUNDS.
2. THE NUMBER OF LICENSEES IN THE MESBIC INDUSTRY HAS GONE FROM A HIGH OF 146 IN 1985 TO OUR CURRENT MEMBERSHIP OF 128.
3. LAST YEAR, THERE WERE THREE COMPANIES LEAVING THE INDUSTRY FOR EVERY ONE COMPANY THAT ENTERED THE INDUSTRY.
4. MESBICS HAVE BEEN FACED WITH A SEVERE FUNDING SHORTAGE FOR SEVERAL YEARS, AND NOW THE ADMINISTRATION HAS PROPOSED THE ELIMINATION OF ALL SPECIAL INCENTIVES FOR THE INDUSTRY.

WE ARE PARTICULARLY CONCERNED ABOUT THE VICIOUS ATTACKS THE ADMINISTRATION HAS LAUNCHED ON THE MESBIC INDUSTRY RECENTLY. IN CONGRESSIONAL TESTIMONY, CONGRESSIONAL CORRESPONDENCE, AND NEWS ARTICLES, THE ADMINISTRATION HAS ACCUSED THE MESBIC INUDSTRY OF ABUSING ITS SPECIAL INCENTIVES, AND NOT FULFILLING THE LEGISLATIVE MANDATE OF THE PROGRAM. NAIC PRESIDENT JOANN PRICE ADDRESSED THESE ACCUSATIONS IN HER MARCH 22 TESTIMONY BEFORE THIS COMMITTEE, AND SHOWED THAT THE ADMINISTRATION IS MISREPRESENTING THE FACTS TO FURTHER ITS GOAL OF ELIMINATING THE MESBIC INDUSTRY.

AND EVEN THOUGH THEY HAVE BEEN UNABLE TO ELIMINATE THE INDUSTRY BY CUTTING OFF OUR FUNDING, THEY HAVE BEEN ATTEMPTING TO DO SO THROUGH THEIR REGULATORY POLICY IMPLEMENTATION. CAPRICIOUS, ARBITRARY, INCONSISTENT AND IRRATIONAL INTERPRETATION OF REGULA-

TIONS CAN BE CERTAIN DEATH TO AN INDUSTRY WHERE HUNDREDS OF MILLIONS OF DOLLARS ARE AT STAKE. WE ACCEPT THE NEED FOR GOVERNMENT OVERSIGHT WHERE PUBLIC RESOURCES ARE INVOLVED. WE WELCOME IT. BUT WE ARE TRYING TO RUN BUSINESSES, NOT WELFARE PROGRAMS. THE SBA DOES NOT SEEM TO UNDERSTAND THIS.

IN EVERY ONE OF OUR COMPANIES, IT IS THE PRIVATE CAPITAL THAT IS FIRST AT RISK. THE LEVERAGE DOLLARS WHICH WE RECEIVE FROM THE SBA ARE OBLIGATIONS, NOT GRANTS.

AS SOMEONE WHO HAS DEALT WITH THE FUNDING AND REGULATORY INSTABILITY AT THE SBA FOR A NUMBER OF YEARS, I COULD NOT HELP BUT TO SENSE A BASIC NEGATIVE VIEW IN THE SBA TOWARD THE PROCESS OF CAPITAL FORMATION. I BELIEVE A LOT OF PEOPLE AT THE SBA VIEW THE MESBIC INDUSTRY AS A PROVERTY PROGRAM, AND ARE UNCOMFORTABLE WITH THE FACT THAT IT HAS BEEN PROFITABLE, AS WAS ORIGINALLY INTENDED. THIS DISCOMFORT WITH PROFITABILITY HAS NURTURED A CERTAIN LEVEL OF HOSTILITY, RATHER THAN A CONTINUATION OF THE PARTNERSHIP RELATIONSHIP WITH BOTH PARTNERS WORKING TOWARD A MUTUAL GOAL.

I'M NOT SAYING THAT THE PRIVATE SECTOR PARTNERS IN THE MESBIC PROGRAM CAN DO IT ON THEIR OWN--IN FACT FAR FROM IT. ON THE OTHER HAND, THEIR CURRENT PARTNERS AT THE SBA SEEM TO BE MORE OF A HINDRANCE THAN A HELP TO THEIR PROGRESS.

MORE SO THAN EVER BEFORE, THE MESBIC INDUSTRY NEEDS COSBI IF WE ARE TO CONTINUE TO SURVIVE. VENTURE CAPITAL IS A BUSINESS THAT REQUIRES ITS EXECUTIVES TO PLAN FOR THE LONG TERM. BUT WE CAN'T

PLAN FOR THE LONG TERM IF WE DOUBT THAT THERE WILL EVEN BE A LONG TERM. EVEN THE GOOD INTENTIONS OF THIS COMMITTEE AND OUR OTHER FRIENDS IN CONGRESS HAVE NOT BEEN ABLE TO SAVE US FROM ARBITRARY POLICY CHANGES, BUDGET CUTS AND SEVERE FUNDING SHORTAGES OVER THE PAST SEVERAL YEARS. WE MUST GO OFF BUDGET AND INTO COSBI IF WE ARE TO CONTINUE TO SURVIVE.

BEFORE I ADDRESS THE ADMINISTRATION'S CRITICISMS OF THE COSBI LEGISLATION, I WOULD LIKE TO PROVIDE YOU WITH A HISTORICAL PERSPECTIVE ON THE MESBIC INDUSTRY'S PARTICIPATION IN THE DEVELOPMENT OF THE BILL. WE ARE NOT JUST GOING ALONG FOR THE RIDE WITH COSBI. OUR INDUSTRY MADE A CONSCIOUS DECISION TO MOVE FORWARD IN TANDEM WITH THE SBICS TO FIND A LONG TERM SOLUTION TO OUR FUNDING AND POLICY PROBLEMS. AND LET ME ASSURE YOU, IF YOU THINK THE SBIC INDUSTRY IS COMMITTED TO COSBI BECAUSE OF THE STABILITY IT OFFERS, THE MESBIC INDUSTRY IS EVEN MORE COMMITTED, BECAUSE COSBI REPRESENTS OUR CHANCE FOR SURVIVAL.

WHEN THE CONCEPT WAS FIRST DISCUSSED, WE HAD SOME VERY SERIOUS ISSUES WE HAD TO FACE BEFORE WE WERE COMPLETELY COMFORTABLE WITH THE IDEA. THESE ISSUES INCLUDED THE FOLLOWING:

1. COULD MESBICS BE PROTECTED AS SMALL PLAYERS IN SUCH A LARGE INVESTMENT VEHICLE?
2. WOULD MESBICS BE ABLE TO CONTINUE TO GET THE SUBSIDIES WE CURRENTLY RECEIVE IN RECOGNITION OF OUR SPECIAL INVESTMENT POLICIES?
3. WOULD MESBICS HAVE EQUAL ACCESS TO THE CORPORATION'S FINANCING WINDOW?

4. COULD WE BE ASSURED THAT WALL STREET WOULD NOT PERCEIVE OUR PARTICIPATION IN THE CORPORATION NEGATIVELY, AND REFLECT THAT IN THE PRICING OF COSBI SECURITIES?
5. WOULD THE COST OF PARTICIPATION IN COSBI BE EQUITABLE FOR MESBICS.
6. WOULD MESBICS HAVE ADEQUATE REPRESENTATION IN THE LEADERSHIP OF THE CORPORATION?
7. WOULD THE CONTINUING FEDERAL PRESENCE IN THE CORPORATION RECOGNIZE THE SPECIAL MISSION OF THE MESBIC INDUSTRY?

WE WEIGHED THE RISKS THESE QUESTIONS PRESENTED. WE SPENT AN EXORBITANT AMOUNT OF TIME AND MONEY SEEKING THE ANSWERS TO THESE QUESTIONS AND DEVELOPING ALTERNATIVES TO ADDRESS OUR CONCERNS. IT WAS NOT UNTIL WE KNEW WE COULD ANSWER EACH AND EVERY ONE OF THESE QUESTIONS POSITIVELY THAT WE AGREED TO MOVE FORWARD AS EQUAL PARTNERS WITH THE SBIC INDUSTRY IN PURSUING THE COSBI LEGISLATION.

HAVING DISCUSSED OUR CONCERNS WITH THE ORIGINAL COSBI CONCEPT, I WOULD NOW LIKE TO ADDRESS THE ADMINISTRATION'S CONCERNS, BEGINNING WITH THE SMALL BUSINESS ADMINISTRATION.

RESPONSE TO THE SBA

IN TESTIMONY BEFORE A HOUSE SMALL BUSINESS SUBCOMMITTEE ON FEBRUARY 25, 1988, SBA ADMINISTRATOR JAMES ABDNOR STATED, "IN CONTRAST TO THE JUSTIFICATIONS GIVEN BY THE PROPONENTS OF THE (COSBI) BILL, IT IS OUR VIEW THAT THE SBIC AND MESBIC PROGRAMS HAVE PROGRESSED TO A POINT IN THEIR RESPECTIVE HISTORIES WHERE A GRADUATION TO THE PRIVATE SECTOR IS CALLED FOR SIMPLY BECAUSE CONTINUED DIRECT HANDS-ON SUPPORT BY THE FEDERAL GOVERNMENT IS NO LONGER NECESSARY OR JUSTIFIED." IN SUPPORT OF THEIR ARGUMENT, THEY CITE THAT MESBIC

FINANCINGS HAVE RISEN FROM $54 MILLION IN 1981 TO $143 MILLION IN 1987. WHAT THEY DON'T TELL YOU IS THAT WE HAD FEWER INVESTMENTS IN 1987 THAN WE HAD IN 1986, A TREND WE EXPECT TO SEE CONTINUE AS MESBICS USE UP THEIR CAPITAL RESERVES AND ARE DENIED ACCESS TO SUFFICIENT FUNDING IN THE FUTURE.

THE SBA ALSO CITES OUR 51% INCREASE IN PRIVATE CAPITAL SINCE 1981 AS A SIGN OF OUR ABILITY TO GRADUATE TO THE PRIVATE SECTOR. WHAT THEY DON'T TELL YOU IS THAT OVER 35% OF THAT INCREASE OCCURED BETWEEN 1981 AND 1983, AND THAT OUR AVERAGE RATE OF GROWTH DURING THE PAST FOUR YEARS, SINCE THE ADMINISTRATION HAS TRIED TO ELIMINATE THE INDUSTRY, HAS BEEN ONLY 4%. IN FACT, FOR THE FIRST TIME IN THE INDUSTRY'S HISTORY, OUR PRIVATE CAPITAL LEVEL DECREASED BY 3% DURING 1987.

THE SBA CONCEDES IN ITS TESTIMONY THAT WE HAVE FUNDING APPLICATION BACKLOGS, BUT STATES IT IS "PRIMARILY BECAUSE OF THE SUBSTANTIAL SUBSIDY AVAILABLE ON THOSE FUNDS" AS IF THE VERY PRESENCE OF THE SUBSIDY SUGGESTS AN INHERENT ABUSE. IT IS PRECISELY THIS ATTITUDE THAT THE SBA HAS DEMONSTRATED TIME AND TIME AGAIN THAT SHOWS THE SBA IS NOT AT ALL CONCERNED ABOUT THE WELFARE OF THE MESBIC INDUSTRY OR THE MINORITY SMALL BUSINESSES WHICH WE FINANCE.

RESPONSE TO TREASURY

IN ADDITION TO COMMENTS ON THE COSBI INITIATIVE IN GENERAL, THE ACTING SECRETARY OF TREASURY GEORGE D. GOULD HAS MADE COMMENTS DEALING WITH THE MESBIC PROVISIONS IN THE LEGISLATION.

FIRST, MR. GOULD SUGGESTS THAT SINCE COSBI'S LOSSES ON ITS PURCHASE OR GUARANTEES OF MESBIC DEBENTURES WOULD BE COVERED BY THE TRUST, THERE WOULD BE LITTLE INCENTIVE FOR COSBI TO SCRUTINIZE THE CREDIT WORTHINESS OF MESBIC ISSUERS.

ALTHOUGH COSBI WILL NOT INCUR LOSSES ON MESBIC DEBENTURES, THE TRUST WILL. AND LET ME MAKE ONE THING VERY CLEAR. IF THE TRUST DIES, WE DIE WITH IT. IF THE MESBIC PROGRAM LOSES THE TRUST FUNDS AND THE SPECIAL INCENTIVES MADE AVAILABLE THROUGH THOSE FUNDS, THE INDUSTRY WILL EXPIRE. PRIVATE CAPITAL WILL NOT BE INVESTED IN THE PROGRAM ABSENT THE MESBIC INCENTIVES. THIS IS CLEARLY DEMONSTRATED BY THE CURRENT DECREASE IN PRIVATE CAPITAL RESULTING FROM UNCERTAINTY SURROUNDING OUR INCENTIVES. IF SUBSIDY UNCERTAINTY PROHIBITS THE GROWTH OF PRIVATE CAPITAL INVESTMENTS IN MESBICS, WE WOULD EXPECT AT LEAST AS MUCH FROM THE SUBSIDY ELIMINATION THAT WOULD OCCUR WITH THE DISSIPATION OF THE TRUST'S ASSETS.

THUS, THE TRUSTEES WILL HAVE A SIGNIFICANT INCENTIVE TO SCRUTINIZE THE CREDIT WORTHINESS OF MESBIC BORROWERS. EACH MESBIC DEBENTURE ISSUED REPRESENTS A COST CERTAIN TO THE TRUST. MESBICS MUST APPLY TO THE TRUST FOR THE FIVE-YEAR DEBENTURE SUBSIDY OFFERED TO MESBICS. AS THE TRUST REVIEWS EACH COMPANY PRIOR TO DEBENTURE SUBSIDY APPROVAL, THEY WILL BE REVIEWING THE CREDIT-WORTHINESS OF THE COMPANY AND THE PROBABILITY OF FUTURE LOSSES.

THE TRUST COVERAGE OF LOSSES FEATURE WAS PUT IN THE BILL OUT OF A CLEAR RECOGNITION THAT THE MESBIC INDUSTRY IS REQUIRED TO INVEST IN A NARROW, HIGH-RISK MARKET. IF LOSS COVERAGE WERE NOT PRO-

VIDED, THIS RISK WOULD BE IMPUTED TO THE SECURITIES ISSUED BY COSBI, AND THE PRICING OF THOSE SECURITIES WOULD INCREASE SUBSTANTIALLY. THE RESULT WOULD EITHER MAKE PRICING IMPRACTICAL FOR THE INDUSTRY, OR CAUSE A SUBSTANTIAL INCREASE IN COST TO SMALL BUSINESS. IF COSBI ATTEMPTED TO ISSUE SEPARATE SECURITIES SOLELY FOR MESBICS, PRICING WOULD BE IMPRACTICAL FOR THE MESBIC INDUSTRY.

MR. GOULD ALSO CRITICIZES THE COSBI PROPOSAL BY CHARACTERIZING THE TRANSFER OF THE EXISTING MESBIC PORTFOLIO FROM THE SBA TO THE COSBI TRUST AS A MULTIBILLION DOLLAR GIVE-AWAY, AND STATES THAT SINCE THE TRUST WILL BE CONTROLLED BY INDUSTRY REPRESENTATIVES, THERE IS LITTLE REASON TO BELIEVE ANY AMOUNTS WOULD BE RETURNED TO THE TREASURY AT THE END OF 50 YEARS. AGAIN, WE NEED THOSE TRUST FUNDS TO CONTINUE TO SURVIVE. IT IS IN OUR OWN SELF INTEREST THAT WE MAINTAIN A HEALTHY, PROFITABLE TRUST IN YEARS 1 THROUGH 50.

BECAUSE OUR CONTINUED EXISTENCE UNDER COSBI HINGES ON THE VIABILITY OF THE TRUST, WE HAVE SPENT CONSIDERABLE TIME AND EFFORT DEVELOPING ITS FRAMEWORK. WE HAVE USED DETAILED DATA FROM THE SBA TO DEVELOP OUR ASSUMPTIONS, AND HAVE PLACED EVEN STRICTER PROVISIONS ON LEVERAGE THAN THAT CURRENTLY USED BY SBA TO INSURE THE FISCAL STRENGTH OF THE TRUST. THESE PROVISIONS INCLUDE PLACING A MANDATORY CALL ON PREFERRED STOCK ISSUED, INSURING AN EVEN HIGHER LEVEL OF PROTECTION FOR THE CORPUS OF THE TRUST. WHEN THE TRUST TERMINATES, THE CORPUS OF THE TRUST WILL REVERT BACK TO THE TREASURY. OUR PROJECTIONS ON THE SIZE OF THE TRUST CORPUS AT THE END OF THE FIFTY YEARS, BASED ON A COMPUTER MODEL, ARE IN EXCESS OF $1 BILLION.

IN THE MEANTIME, THE FEDERAL GOVERNMENT RECEIVES COMPENSATION FOR THE TRANSFER. THE MESBIC PROGRAM IS CURRENTLY FUNDED THROUGH DIRECT APPROPRIATIONS AT AN ANNUAL LEVEL OF $36 MILLION. THE CHAIRMEN OF BOTH SMALL BUSINESS COMMITTEES HAVE ASSURED US OF THEIR INTENTIONS THAT OUR FUTURE FUNDING LEVELS BE AT LEAST AS MUCH. WHEN COSBI IS ENACTED, HOWEVER, THE NEED FOR THESE DIRECT APPROPRIATIONS WILL CEASE. CONSEQUENTLY, IN JUST SEVEN YEARS THE BUDGET SAVINGS OF $252 MILLION WILL EXCEED THE VALUE OF THE ASSETS BEING TRANSFERRED TO THE TRUST.

ALSO IN ANSWER TO MR. GOULD'S CHARGE OF THE TRANSFER OF ASSETS BEING A MULTIBILLION DOLLAR GIVE-AWAY, IT IS IMPORTANT TO RECOGNIZE THAT THIS IS SIMPLY A TRANSFER OF ASSETS, AND DOES NOT IN ANY WAY CONSTITUTE A GIVE-AWAY OF ANY PROPORTIONS. THE TRANSFER OF THE MESBIC PORTFOLIO IS A TRANSFER OF ASSETS TO A TRUST. OWNERSHIP REMAINS WITH THE GOVERNMENT. THE TRUSTEES ARE OBLIGATED TO MANAGE THOSE ASSETS IN TRUST FOR THE FEDERAL GOVERNMENT FOR A FIXED PERIOD OF TIME, UNDER FIDUCIARY STANDARDS ESTABLISHED BY LAW. IN FACT, WE ANTICIPATE THE TRUSTEE'S MANAGEMENT OF THOSE ASSETS WILL BE A SUBSTANTIAL IMPROVEMENT OVER THEIR CURRENT MANAGER, THE SBA.

IN SUMMARY, MR. GOULD'S COMMENTS DEMONSTRATE A LACK OF UNDERSTANDING OF THE MESBIC INDUSTRY. ONLY SOMEONE UNFAMILIAR WITH OUR OPERATIONS AND NEED FOR THE SPECIAL INCENTIVES PROVIDED BY THE TRUST WOULD SUGGEST THAT WE WOULD OPERATE IN A MANNER THAT WOULD ENDANGER THE CONTINUED EXISTENCE OF THE TRUST FUNDS.

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Additional Comments

NAIC has already covered the MESBIC trust in detail in testimony presented by NAIC Chairman Divakar Kamath before this Committee on February 24, but there are a few other sections of the bill that specifically address the MESBIC industry, and I would like to cover those areas now.

Capital Structure

The initial capitalization of the Corporation will come from the SBICs and MESBICs. In order to do business with the Corporation, each SBIC will be required to purchase COSBI common stock equal to 1% of the SBIC's private capital, plus 1% of the leverage the SBIC has received. MESBICs, which tend to have a lower capitalization level and a higher leverage level than regular SBICs, are required to purchase COSBI common stock equal to 1% of private capital, plus 1% of either their preferred stock leverage of their debenture leverage, whichever is larger. This provision ensures that MESBICs, because of their higher leverage level, will not pay an unreasonably high percentage of their assets for COSBI partipation relative to regular SBICs.

Organization and Management

COSBI's board of directors will consist of 15 persons. Nine of the board members will be elected by stockholders through cumulative voting rights. Five of the members will be appointed by the

PRESIDENT. THE REMAINING BOARD MEMBERS WILL BE SELECTED FROM THE MESBIC INDUSTRY. THIS MANDATORY BOARD REPRESENTATION OF A MESBIC REPRESENTATIVE WAS ABSOLUTELY ESSENTIAL IN THE INDUSTRY'S SUPPORT OF THE BILL. ALTHOUGH WE KNEW WE COULD NOT REASONABLY INSIST ON WIDE REPRESENTATION ON THE BOARD, THE ASSURANCE OF AT LEAST ONE PLACE, WITH THE POSSIBILITY OF OTHERS THROUGH STOCKHOLDER ELECTIONS, GAVE US THE LEVEL OF ASSURANCE WE NEEDED TO KNOW THAT THE MESBIC INDUSTRY'S INTERESTS WOULD RECEIVE ADEQUATE REPRESENTATION IN POLICY DECISION-MAKING.

FINALLY, I WOULD LIKE TO TAKE THIS OPPORTUNITY TO SUGGEST A CHANGE WE WOULD LIKE TO SEE IN S. 1929.

WE WOULD PREFER TO SEE ANY POSSIBILITY OF DIRECT REGULATION OF MESBICs AND SBICs BY THE SBA ELIMINATED. AS I HAVE ALREADY DEMONSTRATED IN SOME DETAIL, WE ARE CONVINCED THAT THE SBA WOULD PREFER TO ELIMINATE THE MESBIC INDUSTRY, AND THAT IT WILL USE EVERY OPPORTUNITY TO ACHIEVE THAT GOAL. A REGULATORY STRUCTURE SIMILAR TO THAT CONTAINED IN THE HOUSE VERSION OF THE LEGISLATION, H.R. 3392, WOULD BE MUCH MORE PREFERABLE. THE GOVERNMENT WOULD HAVE CONTINUED OVERSIGHT OF THE INDUSTRY THROUGH REPORTING REQUIREMENTS AND AUDITS OF THE CORPORATION ITSELF, BUT THE SBA WOULD BE REMOVED FROM ITS DIRECT REGULATORY ROLE OVER MESBICs.

CONCLUSION

SENATOR WEICKER, WE KNOW THAT YOU, CHAIRMAN BUMPERS, AND THE OTHER MEMBERS OF THIS COMMITTEE ARE FRIENDS TO THE MESBIC INDUSTRY.

WE KNOW THAT YOU SUPPORT OUR GOAL OF DEVELOPING THE MINORITY BUSINESS COMMUNITY. WHAT WE DON'T KNOW IS WHETHER YOU HAVE HEARD US AS WE HAVE WARNED YOU THAT OUR INDUSTRY IS DYING. WE ARE LOSING COMPANIES. WE ARE LOSING MONEY. AND THE MINORITY SMALL BUSINESS COMMUNITY IS LOSING ACCESS TO VENTURE CAPITAL.

YOU CAN SAVE US. BUT WITH THREE COMPANIES LEAVING THE INDUSTRY FOR EVERY ONE COMPANY ENTERING, THERE ISN'T MUCH TIME. WE NEED COSBI, AND WE NEED IT NOW.

THANK YOU.

MESBIC INDUSTRY STATISTICS

	Number of Companies					Private Capital			
Year	New Cos.	Outgoing Cos.	Total	Change	%Change	New Priv. Cap.(000)	Tot. Priv. Cap.(mil)	Change	%Change
1978	20		91			13,838	65.5		
1979	28	9	110	19	20.83%	12,316	82.1	16.6	25.34%
1980	31	12	129	19	17.27%	17,658	104.6	22.5	27.41%
1981	16	18	127	-2	-1.55%	11,136	116.7	12.1	11.57%
1982	11	3	135	8	6.30%	6,688	129.4	12.7	10.88%
1983	21	12	144	9	6.67%	13,789	146	16.6	12.83%
1984	9	7	146	2	1.39%	7,140	160	14	9.59%
1985	13	14	145	-1	-0.68%	14,146	168	8	5.00%
1986	[illegible]	16	137	-8	-5.52%	8,030	178	10	5.95%
1987	[illegible]	18	128	-9	-6.57%	6,500	172.4	-5.6	-3.15%

Senator **Weicker**. Thank you very much, Mr. Greene. Jim (Abdnor, SBA Administrator), since you have left the witness stand, I have been presented a letter which you sent to Chairman Bumpers in response to Chairman Bumpers' request for an evaluation of this proposal by an outside consultant.

[The material follows:]

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United States Senate
COMMITTEE ON SMALL BUSINESS
WASHINGTON, DC 20510-6350

January 15, 1988

The Honorable James Abdnor
Administrator
Small Business Administration
1441 L Street, N.W.
Washington, D. C. 20416

Dear Jim:

On December 8, 1987, we introduced S. 1929, a bill to establish the Corporation for Small Business Investment (Cosbi). Hearings will be held in the Small Business Committee early in the year and we will, of course, ask for your views and comments, as well as those of others in the Administration.

S. 1929 was developed by the Senate Committee staff working in close cooperation with NASBIC, the National Association of Small Business Investment Companies. Having received and reviewed the recent report of SBA's financial advisor on asset sales, Paine Webber, it occurred to us that a similar comprehensive study of the Cosbi proposal would be helpful to both the Committee and the Administration. Since we anticipate objections to Cosbi by OMB, the Treasury Department and perhaps others, it seems in the interest of all concerned to have as complete information as possible.

We are writing to request that you and your staff promptly undertake discussions with Paine Webber or other appropriate parties to determine whether such a comprehensive financial analysis by an unbiased third party could be developed in a time frame which would be helpful in light of next year's compressed legislative schedule.

In particular, the Committee would benefit from an impartial analysis and evaluation of the following issues, based on the current model for Cosbi developed by NASBIC and its consultants.

1. What assumptions are being made about Cosbi's profit margin (interest on loans less cost of funds and operating expenses) from its lending activities? How does Cosbi's profit margin compare to those of finance companies that take similar risks?

2. Would Cosbi's lending activities keep it viable without the capital provided by the explicit government

equity and its profits from the SBIC portfolio? If so, for how many years?

3. What if Cosbi's default assumptions were accelerated to the earliest years of its new loans (a "depression scenario")? To what extent does Cosbi's viability in such a scenario depend on explicit government equity and profits from the SBIC portfolio?

4. How should the SBIC portfolio be evaluated? What is the internal rate of return (implicit interest rate) in Cosbi's investment in the portfolio? What is the present value of the SBIC portfolio discounted at the same rate at which SBIC Funding Corporation currently issues participation certificates?

5. At what level should Cosbi establish its reserve for losses? How does this level compare to those of finance companies that take similar risks?

6. What will Cosbi's debt to equity ratio be at inception? In five years? In ten years?

7. What return on equity will Cosbi generate at inception? In five years? In ten years?

8. What assumptions are made about Cosbi's investment of idle cash? How does the rate compare to assumptions typically used by other finance companies?

9. How can Cosbi improve on SBA's historical loss rates?

10. Will Cosbi operate under different lending eligibility criteria, loan enforcement (including deferral and rescheduling) policies, and roll-over criteria than SBA now does?

11. Will Cosbi effectively alter the mandate of the SBIC lending program as it is now administered by the SBA?

We appreciate your consideration of this request. Please feel free to contact John Ball or Bob Dotchin of the Committee staff for further discussion.

Sincerely,

Dale

Lowell Weicker, Jr.
Ranking Minority Member

Dale Bumpers
Chairman

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE ADMINISTRATOR

FEB - 4 1988

Honorable Dale Bumpers
Chairman
Committee on Small Business
United States Senate
Washington, DC 20510-6350

Dear Mr. Chairman:

This responds to your January 15, 1988, letter in reference to S.1929, which you introduced December 8, 1987 and which, if enacted by the Congress and approved by the President, would establish the Corporation for Small Business Investment (COSBI).

Your letter requests that SBA undertake discussions with Paine Webber or other appropriate parties leading to a comprehensive financial analysis of the COSBI proposal and its feasibility. It further suggests specific questions that an analysis should seek to answer.

The COSBI bill is one that has been introduced on several occasions in the past in both the House of Representatives and the Senate in fundamentally the same form. SBA, representing the Administration, has testified directly on these bills, and the OMB and the U.S. Treasury have directly provided the Committees their written comments on the bills. That testimony and those comments set forth some very fundamental objections of the Administration which have yet to be resolved.

It is our opinion that there is little value to SBA of further financial analysis or feasibility studies. Also, since this bill is not supported by the Administration we do not feel it is appropriate for SBA to commission, or be charged with the expense of any such analytical activity. If, however, the Committee should contract for the analysis, SBA stands ready to cooperate in any way possible with the Committee's efforts.

We trust you understand our position on this request and please contact me if you feel further discussion would be beneficial.

Sincerely,

James Abdnor

James Abdnor
Administrator

Senator **Weicker**. You say in your letter, "your letter requests that SBA undertake discussions with Paine Webber and other appropriate parties leading to a comprehensive financial analysis of the COSBI proposal and its feasibility. It further suggests specific questions that an analysis should seek to answer." Yet, you say, "it is our opinion that there is little value to SBA of further financial analysis for these feasibility studies. Also, since this bill is not supported by the Administration, we do not feel it is appropriate for SBA to commission, or be charged with the expense of any such analytical activity."

I would have to agree with the comments of Mr. Greene and Mr. Jones, that for all of the lipservice the Administration gives, both in a regulatory sense and in a funding sense, it has not been supportive of the SBICs. What comes through loud and clear here is a rather negative message to the SBIC concept.

Now, I might be able to live with that, and I say "might," were it not for a very important change that took place in the tax laws in 1986 in which we eliminated the capital gains tax.

I have got to say to you that I am a great believer in small business and having the capital available for small businesses to be established and to expand. I believe this principally for the reason that these are the businesses which supply the jobs and will create the competition that gives to the public higher quality products at lower prices.

The combination of the elimination of capital gains tax differential and the negative attitude on SBICs is a deep concern to me.

That is why I said at the outset that if there were some adjustments to be made here, and I think possibly there should be, that is one thing, but, if the Administration is saying no way, then, very frankly, I am just going to move ahead and try to get this enacted into law without Administration participation.

I understand from your testimony on the matter of SBA regulatory authority, you don't want it. I can understand why, but what if you had a gradual relinquishing of that authority. What if it were relinquished over a period of time, might that be a way that we could go?

I know how much time has been spent on this issue. An issue I find very difficult to comprehend, is that this Administration, which believes in the private sector so much, is giving the back of its hand to an institution that really is carrying the ball for all of us when it comes to funding small businesses.

Conceptually I don't understand that, I really don't. In any event, I would like Senator Kasten to have some time. I know he has taken the time to be here.

Let me turn it over to Senator Kasten for some questions.

STATEMENT OF HON. ROBERT W. KASTEN, JR., A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator **Kasten**. Mr. Chairman. I would like to associate myself with your views. A number of us have, over more than 1 or 2 years, have tried to work this through. Where there were specific objections we have tried to deal with those specific objections. Where there were problems we have tried to deal with the problems.

The fact is that we unfortunately have an Administration that for one reason or another is not sympathetic. I think that we have got a majority in the House of Representatives and I think we have got a majority in the Senate. We probably have enough votes to override a veto if that should occur. It seems to me that you are right, and that what we ought to do is to move forward and we ought to pass this legislation.

We have got maybe 50 days of the legislature to go this year, when you count the time off for the political conventions and the fact that we will be out early because it is a campaign year. The recesses that are already scheduled, and I share your frustration and the frustration of many people in this room, because it is some of the same faces that have been here for two or three of the other hearings.

At one point I think we simply have got to move forward. This question about the relationship between the Small Business Administration and between the SBICs, you brought it up in your testimony, and I am sorry, Mr. Jones, that I missed your testimony, but is this an adversary relationship? What is going on here? I just caught the couple of comments that you had made and they were kind of throw-away comments to the effect that the last thing we need is to have more regulators and regulations. On top of this we have, you seemed to suggest and, I don't want to put words in your mouth, that we already have not only overregulation, but a kind of an adversary relationship.

Could you describe that in a little bit more detail for me?

Mr. **Greene**. I guess there are two levels to view it. One is a budget consideration, where we have been zeroed out of the budget and sharply reduced in leverage appropriations and requests, and the second level of concern would be that there are a number of fairly arbitrary policies and rules in force from time to time by the SBA. These were unwritten policies and rules that leave you sort of open and vulnerable.

Senator **Kasten**. What would be a specific example of an unwritten policy or rule?

Mr. **Greene**. There are concerns, for example, in the industry about compensation levels for staffing. The SBA will, from time to time, come in and suggest that people are being paid too much or need to have staff reductions. These are not written regulations. These are just fairly arbitrary imposition of policy of MESBICs. And there have been a number of regulatory changes that our industry has not been terribly happy with.

Dave, do you want to add anything to that?

Mr. **Jones**. Senator, I think we have had testimony from a number of SBICs who have related instances of what they consider to be arbitrary policies or activities with regard to their own SBIC investment policies which are inconsistent, and so forth. Let me say I think I agree with Don Greene that there are two pressures. One is the monetary or the fiscal pressure, if you will, of the budget appropriations process which has been so inconsistent, and then there is the budget process on SBA.

Now, SBA, when I first came into the business in 1972, I found it to be cooperative, understanding of the business, aware of our policies, aware of how we do deals, and so on. These are fine people at the SBA who do the best possible job they can under their own trying circumstances because they themselves are subject to budget reductions, and so on, and I think we have seen a position of, in the face of their own staff reductions, an inability to maintain their contact with the industry and to really understand how it is that the industry functions, and so that when we do try to propose given actions at any given time we are no longer certain that we are talking to people who really have that understanding of our business.

Senator **Kasten**. Let me try to separate. There are three or four things that you are talking about. All of us understand that there are financial constraints. We have Gramm-Rudman in place. We have other things in place and, as all of us in this room understand, the Small Business Administration isn't OMB's favorite agency anyway. There have been a number of different proposals over the past several years, but I think we have now reached a kind of a balance, that with limited resources we are going to do the job, but what you are also saying to me is that with limited resources you are getting overregulated and/or oversupervised with nonspecific kinds of pressures that aren't written down. Are you saying that that person is walking in with more of an adversarial kind of a point of view than they had a couple of years ago? I mean, I can't tell what the problem is.

It seems to me that if we cut down on the number of inspectors or cut down on the number of regulators, you are less likely to be overregulated. What you are saying is the opposite is taking place.

Let me just preface this by saying that the people, including Jim Abdnor, who is sitting behind you, I know are people who, at least in their hearts, believe in small business and growth in jobs. They understand the jobs are coming not from the Fortune 500 companies. But, your testimony isn't consistent with what I know of at least the people at the top of the Small Business Administration. Could you both comment on that?

Mr. **Greene**. One area of special concern to us and, that is, the SBA has continued to try to eliminate special financial incentives that have been made available to MESBICs, which in effect would put in place——

Senator **Kasten**. Just a second. The Small Business Administration has been making recommendations to who, OMB, to eliminate?

Mr. **Greene**. To eliminate preferred stock purchases from MESBICs and to eliminate the 3 percent discount, if you will.

Senator **Kasten**. This is a stated policy of SBA?

Mr. **Greene**. Yes, absolutely.

Senator **Kasten**. That is what we need, specific examples like that, and then we can find out why they are doing that, which would seem to be inconsistent.

Mr. **Greene**. Their desire to withdraw those incentives shows a great deal of insensitivity to the marketplace that we serve with its specific risk characteristics and dynamics.

Mr. **Jones**. Let me say, Senator, that I share your puzzlement. As I mentioned earlier, this was not a case that we think existed, say, 10 years ago, this attitude, the adversarial relationship.

Senator **Kasten**. I felt we had a group of people that were anti-jobs growth, small business development, and what you are saying to me is that the group of people we have today are anti-jobs growth, small business development. That the group of people we had 10 years ago were in favor of jobs, growth, development. That isn't consistent with my overall thinking.

I wonder, there is no purpose in pursuing this further, if you or someone could give the Committee a specific list of either unnecessary overregulation or specific kinds of complaints. I think to the degree we can be specific and have things down on a piece of paper, even if we don't pass this legislation we might be able to deal with those 2 or 3 or 10 or 30 different areas.

Mr. **Jones**. I think we certainly can make that available to you immediately. There is a list, I don't know if it is directly responsive to your request, but it does set out a scenario of the last several years and the activities and actions by the SBA that have caused this upheaval in the industry and it is included as part of my forewritten testimony.

I would like to make one more point, if I may, just simply before we get off this. It is an important one because the Administrator brought it up.

He asked, Senator, if you would make an investment in a company which had this kind of control arrangement, where all of the money is going in and you weren't getting control of the board or you didn't have sufficient control over management and whether any of us in the SBIC business would even do such a deal? The fact is, Senator, we do those deals every day of the week, every day of the year. Those are the types of deals we do.

We put in a half a million dollars in a company or a million dollars in a company. We don't control the board. We take one seat on the board. The management runs the company. And the reason those companies work in that regard and the reason the process works is because the incentives are good. They are appropriate. The management and investors have the same goal in mind. That is what we have worked for 4 years to construct here, a system where the incentives and the goals are consonant and everybody can work there, and we have a set of controls that is imposed on it by the oversight and the other aspects of the legislation.

So just to say that because we are putting all of the money in and we don't control the board makes it a bad deal is poppycock.

Senator **Kasten**. I have been given the, if you were referring to the page that you have entitled "Litany of Program Disruptions and Mid-Stream Policy Changes, 'I think that what I will do just on my own is give the Small Business Administration the opportunity to kind of reply to this. Maybe some of these things are good things but maybe some of these things were done that SBA didn't realize what they were doing or, in certain other cases, maybe you are exactly right or maybe you are wrong. But it would be helpful if they had a chance, if we had both sides out in front of us, and maybe in the process of doing this we can reverse some of the things that you find more egregious.

The other difficulty with this issue for some of us is we are not able to spend enough time at it. I am caught right now, supposed to be in two other different kinds of meetings and I am sure that most of this Committee has found itself in the same way, but I want to spend a little bit more time on this and, to begin with, I will make arrangements to use this list and to give SBA an opportunity in an organized way to respond to it, and from this maybe we can move forward.

Thank you, Mr. Chairman.

Senator **Weicker**. Thank you very much, Senator Kasten. I associate myself with all of your questions and observations.

I have no further questions. I am deeply troubled, I will be very honest with you, however, I am deeply troubled. I say this to you, Jim, with you in the room, it isn't just the Administration's opposition to this bill, but I am deeply troubled by the Administration's budget proposals; the 60 percent increase in examination fees; the 1 percent increase in user fees; the reduction of Federal guarantee of the SBIC debentures from 100 percent to 90 percent; the reduction of program level from $233 million to $150 million; and elimination of $38 million of direct lending for MESBICs. I didn't really come into this hearing to debate the wisdom of SBICs because, very frankly, I am a huge supporter of the programs. There are no ifs, ands or buts to that, but I am also supportive of this other program, but I am beginning to get the message that the Administration is a supporter of neither this bill nor the SBICs. That would be disastrous. That would be disastrous.

I think that Senator Kasten will send you these matters that have been raised to comment on and I might have other questions for you to comment upon.

Thank you, gentlemen.

Our last two gentlemen are Mr. Thomas H. Stanton, Wellford, Wegman & Hoff and Mr. James E. Murray, Brown and Wood. Your written statements in their entirety will be accepted for the record. I would appreciate hearing your remarks and there may be questions. I have to close this hearing down at 11 o'clock, so let's get right to your remarks.

STATEMENT OF THOMAS H. STANTON, ATTORNEY, WELLFORD, WEGMAN & HOFF, WASHINGTON, DC

Mr. **Stanton**. Thank you, Mr. Chairman. I am Thomas H. Stanton, a Washington, DC, attorney. One of my legal specialties concerns Government-sponsored enterprises. The purpose of my statement today is to alert the Committee to the need to design COSBI and its regulation to avoid serious financial harm to COSBI and to the Federal Government and, also, to avoid serious harm to the good name of this Committee.

These are troubled economic times. Bank and thrift institution failures are at record levels. Other financial institutions, including the stock market, investment banking, houses and mortgage insurance companies, are showing signs of weakness. Congress has just had to provide a multi-billion-dollar bailout to a major Government-sponsored enterprise, the Farm Credit System.

With these warning signs plain to see, Congress cannot afford to take chances with COSBI's financial soundness. I would note that, as designed in S. 1929, COSBI has many of the structural problems that helped to bring down the Farm Credit System. Those problems should be corrected.

In my testimony today I would like to make five basic points.

One, COSBI is designed to use implicit Federal backing to support billions of dollars of loans to Small Business Investment Companies (SBICs).

Two, because of the Government guarantee, investors in COSBI's securities will not care much about the creditworthiness of COSBI or of the SBICs that COSBI lends money to. Investors instead will look to the implicit Government backing for their assurance. This weakens market constraints that help protect the safety and soundness of private firms without COSBI's Federal support.

Three, because of COSBI's design under S. 1929, COSBI stockholders will have little capital at stake if COSBI takes excessive risks and fails. SBICs need contribute only $20 to $25 million to start a corporation authorized to lend them literally billions of dollars. It is the Federal Government that has substantial financial exposure if COSBI fails. As with the Farm Credit System, that exposure is potentially much greater than the mere half billion dollar Treasury line of credit provided in S. 1929.

Four, because of the structure of the COSBI board of directors and other provisions of S. 1929, COSBI shareholders are likely to secret terms as borrowers from COSBI. They will be interested in a large volume of COSBI lending to SBICs. They will be disinterested in COSBI imposing constraints to protect itself against bad loans.

Five, S. 1929 provides for general regulatory authority by the Government. This makes it far superior to earlier versions of the bill. However, this provision must be strengthened by a variety of protective provisions now lacking in S. 1929. As presently drafted, the bill fails to constrain unnecessary risktaking and fails to promote COSBI's safety and soundness, especially compared to other enterprises such as Fannie Mae and Freddie Mac and as compared to the legislation passed last year by Congress, creating a new enterprise called Farmer Mac.

In his prepared remarks, the next witness, James Murray, takes issue with my testimony. I would like to respond now.

He makes two basic arguments against regulation. First, Mr. Murray says that the Government should not regulate COSBI because COSBI is private. I respectfully differ. The Government regulates private companies all of the time for all sorts of reasons. National banks are a prime example. Like COSBI national banks are privately owned. Like COSBI they have Federal charters. Like COSBI they are considered Federal instrumentalities. Like COSBI's implicit guarantee, national banks have Federal deposit insurance to enhance their lending.

Of course the Government closely regulates national banks. Banks are regulated to restrain unnecessary risktaking and to protect financial safety and soundness. Such regulation is essential for COSBI as well.

Mr. Murray cites a number of provisions in S. 1929 as protective of the Government's interest. As explained in detail in my written statement, many of those provisions have been crafted to have no teeth. They amount to far less protection for the Federal Government than the Government now has in regulating the safety and soundness of national banks, Fannie Mae or Farmer Mac.

Second, Mr. Murray cites the regulatory problems between Fannie Mae and its regulator, the Department of Housing and Urban Development, known as HUD. These problems have been well studied. In its excellent analysis of Fannie Mae—U.S. General Accounting Office, "The Federal National Mortgage Association In A Changing Environment," GAO/RCED-85-102, at pages 100-102 (April 15, 1985)—the U.S. General Accounting Office concludes that HUD's problem is that Congress did not spell out HUD's regulatory mission. The regulator simply doesn't know what it is supposed to do with Fannie Mae. This Committee can now learn from that problem and can spell out the regulator's responsibilities for COSBI.

Regulation is needed for two purposes. Most important, regulation can help control COSBI's costs to the Federal Government, which is to say financial soundness. That's the cost side of the equation.

Second—and I don't talk about the benefits side of the equation in my oral remarks; it is in the prepared testimony—regulation can help the Committee to maximize COSBI's benefits. COSBI is a Federal instrumentality and, as such, should be targeted to serve the highest priority credit needs of small business. Regulatory oversight can help assure that those public purposes are served and not merely the needs of the SBIC's who want to own and control COSBI.

In contrast to Mr. Murray, I believe that this Committee can and should provide for effective regulation to make COSBI a credit to the Congress and a benefit to the American small business community.

Thank you.

[The prepared statement of Mr. Stanton follows:]

Statement of

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On S. 1929,

Legislation to Create the Corporation

for Small Business Investment

Presented to

The Committee on Small Business

United States Senate

March 31, 1988

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Statement

Mr. Chairman, Members of the Senate Committee on Small Business:

Thank you for the invitation to testify on S. 1929, a bill to create a Corporation for Small Business Investment (COSBI). My name is Thomas H. Stanton, and I am a partner in the Washington, D.C. law firm of Wellford, Wegman, and Hoff.[*] One of my legal specialties concerns government sponsored enterprises.

The purpose of my statement is to alert the Committee to the need to structure COSBI carefully to assure its long-term financial viability. In the past troubled economic year, banks and thrift institution failures have been at record levels, and bank profits have fallen to their lowest point since the Great Depression. Congress has just devised multibillion dollar assistance to another government sponsored enterprise, the Farm Credit System.

With these warning signs plain for all to see, it is imperative that this committee carefully draft the statutory language creating COSBI to assure long-term safety and soundness of the institution. If COSBI is created as a strong institution, then the enterprise can provide an increasing range of benefits to the small business community over the years; if the COSBI legislation has structural flaws, then COSBI's failure could provide one more disappointment to American small business and would reflect adversely on this committee and its efforts.

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In creating a government sponsored enterprise to serve small business financial needs, this committee can draw upon decades of federal experience with other enterprises, the Farm Credit System institutions, the Federal Home Loan Banks, Fannie Mae, Freddie Mac, and Sallie Mae. These enterprises have served the credit needs of farmers, thrift institutions, homebuyers, and students for many years.*/

This testimony makes the following six points:

1. This committee has made a great improvement over earlier versions of the COSBI legislation by providing for SBA regulation and oversight of COSBI. However, it is important that this section be supplemented by other protective provisions to assure effective supervision that

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*/ Last year, Congress created two new enterprises, the Financing Corporation (FICO) of the Federal Home Loan Bank System to help provide funds for the faltering Federal Savings and Loan Insurance Corporation, and the Federal Agricultural Mortgage Corporation (Farmer Mac), to provide a secondary market for agricultural mortgages.

can constrain unnecessary COSBI risk-taking and promote the institutions's safety and soundness. Such supplementary provisions could be modelled on those found in the legislation governing Fannie Mae, for example.

2. Such protective provisions are important because COSBI is designed to use implicit government backing to guarantee billions of dollars of SBIC securities. As presently drafted, S. 1929 makes COSBI an institution more prone to fail than are enterprises such as Fannie Mae and Freddie Mac.

3. Because of the government guarantee, COSBI will not be bound by normal market-place constraints on risk-taking. Investors will not care much about the credit quality of COSBI, or of the SBIC securities COSBI deals in. They will look to the implicit government backing for their financial security.

4. Because of provisions in S. 1929, COSBI stockholders will have little capital at stake if COSBI takes excessive risks and fails. COSBI merely needs a few million dollars to start a corporation authorized to deal in billions of dollars in securities. It is the government that has substantial financial exposure if COSBI fails. As happened with the Farm Credit System, the amount of the government exposure can far exceed the modest half billion dollar Treasury line of credit provided S. 1929.

5. Because of the structure of the COSBI Board of Directors, particularly the working control S. 1929 provides to directors representing SBICs, COSBI shareholders are likely to seek their returns as users who are doing business with COSBI. For example, SBIC users of COSBI will be interested in doing a large and profitable volume of business with the enterprise. They will be less enthusiastic about COSBI constraints imposed to assure credit quality of the SBIC securities COSBI buys or guarantees. This structure is far inferior to Fannie Mae's control by investor-stockholders of publicly traded stock. The COSBI structure distorts the Corporation's incentives and increases its propensity to incur risks.

6. I urge this committee to scrutinize the technical provisions of S. 1929 very carefully. A government sponsored enterprise is an extremely powerful tool of federal policy and the practical details of its charter act can mean the difference between large scale success and large scale failure.

In short, the COSBI draft legislation now before this Committee, S. 1929 does provide that the Small Business Administration shall have general regulatory authority over COSBI and the ability to make legislative-type regulations to assure that the purposes of the act are carried out.

This is an important advance over earlier COSBI proposals. Nevertheless, the legislation is seriously flawed because of its lack of other necessary protective provisions to assure effective regulation of COSBI and of the Small Business Investment Companies (SBICs) that make use of federally supported credit channeled through COSBI. This flaw is compounded by COSBI's structure as an institution controlled by its users, the SBICs, rather than by a broad range of investors. While the bill could have been structured without these shortcomings, its flaws greatly increase COSBI's susceptibility to failure, and the consequent risk to the federal taxpayer that a bailout may ultimately be needed. The bill compounds the problem of inadequate regulation by its failure to give COSBI a Fannie Mae-type structure to enhance COSBI's ability to serve this committee and channel federally supported credit to meet the highest priority credit needs of American small business.

I. COSBI's federal backing removes market discipline that otherwise would limit unnecessary risk-taking and help promote long-term financial viability

As with the other government sponsored enterprises, COSBI is designed to use implicit federal government backing to issue and guarantee billions of dollars of securities.*/ Because of the government guarantee, investors will not care much about the creditworthiness of COSBI, or the Small Business Investment Company assets it deals in; instead, investors will largely look to the implicit government backing for their assurance.

For a normal corporation, without such federal backing, investor concern about creditworthiness provides an important marketplace constraint on risk-taking. First, shareholders have a long-term interest in protecting and enhancing a capital investment in the company. For COSBI, however, the draft legislation significantly reduces the financial stake of COSBI investors by limiting the amount of required shareholder capital to a few million dollars before COSBI may begin issuing or guaranteeing potentially billions of dollars of SBIC related securities.[*/] While COSBI's management may in fact develop prudent business policies, the bill provides considerable incentive to seek extra returns by taking excessive risks. Heads, the corporation and its shareholders win; tails, the U.S. taxpayer pays for any mistakes.

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*/ The attached article analyzing the 1986 COSBI legislation, discusses the nature of the government's backing and other benefits provided to government sponsored enterprises.

Market discipline normally also comes from investors other than shareholders. Without the federal government's backing, a corporation is subject to considerable restraint when it issues debt obligations or guarantees securities. Before investors rely upon the obligation or guarantee, they require assurances about the company's financial backing. Investors check not only the balance sheets of the corporation providing the obligation or guarantee, but also the credit quality of the assets standing behind the obligation or guarantee. Before purchasing unsecured debt obligations of a private corporation, investors require assurances about

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[*/] COSBI's required shareholder capitalization under Section 353(a)(4)(A) and (C) seems to amount to about $25 million; under Section 352(d) the Corporation may constitute its permanent board after shareholders have fully paid for $20 million of common stock. Section 361 provides for the sale of government assets to COSBI with the government accepting COSBI preferred stock and warrants as part of the sales price. However, that provision would make the government a part-owner of COSBI and therefore would require inclusion of COSBI within the federal budget. Such a result is not likely to be acceptable to this Committee.

the corporation's balance sheet, including credit quality of assets it holds, the corporation's debt-to-equity ratio, and the corporation's general creditworthiness.

Similarly, before purchasing loan-backed securities issued or guaranteed by a private corporation, investors require assurances about the credit quality of the underlying loans, the credit quality of the loan pools, and the particular safeguards to assure that, in case of default, investors have sole recourse to the mortgage assets.

However, investors in COSBI's securities are unlikely to provide such market discipline because COSBI relies on the federal government's backing to sell its obligations and guarantee. Investors in COSBI securities will be spared the need for much examination of the creditworthiness of COSBI, its assets, or asset pools. Instead, they can be expected to rely largely upon the implicit federal backing upon which COSBI's obligations and guarantees will be based.

This reliance upon the federal government rather than upon COSBI's creditworthiness and the asset quality of the related SBIC securities means that COSBI can take much greater risks than could a private company in this line of business. COSBI will have an extensive market for its debt obligations and guarantees even if, for example, it is undercapitalized and it does not adequately police the credit quality of assets it buys or securities it guarantees.

II. COSBI requires effective regulation as a substitute for missing market discipline

Because the federal government's guarantee removes much of the usual market discipline, effective government regulation is essential to help contain COSBI's risk-taking and help assure its long-term viability.*/ Section 360(h) of S. 1929 addresses this need by providing the Small Business Administration with general regulatory authority to issue legislative-type regulations to assure that the purposes of the act are carried out. This is an important statutory safeguard. However, other statutory protections are also needed to supplement general regulatory authority.

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*/ There is an extensive literature on this point concerning a variety of financial institutions with borrowing implicity backed by the federal government. See e.g., Mark J. Flannery, "Deposit Insurance Creates a Need for Bank Regulation," pp. 17-27, Business Review, January/February 1982, Federal Reserve Bank of Philadelphia; Fischer Black, Merton H. Miller and Richard A. Posner, "An Approach to the Regulation of Bank Holding Companies," Journal of Business, Vol. 51, No. 3, (1978), pp. 379-412; Sherman J. Maisel, Ed., Risk and Capital Adequacy in Commercial Banks, especially Chapter 6 (1981); see also Kevin E. Villani, "The Federal Forecast," Secondary Mortgage Markets, Spring 1985, pp. 26-33, Federal Home Loan Mortgage Corporation; and Edward J. Kane, "Comment," pp. 181-189, The Federal National Mortgage Association in a Changing Economic Environment (Symposium), U.S. General Accounting Office, July 17, 1985.

There has been substantial analysis of effective means to regulate safety and soundness of insured depository institutions, and it is possible to combine those insights with experiences from regulation of government sponsored enterprises such as Fannie Mae.

A number of important protections could be built into the COSBI legislation to strengthen the corporation as an instrument of federal policy. Because many of these protections are found in the Fannie Mae Charter Act, that law can provide a good benchmark for evaluating the COSBI provisions. In particular, control over COSBI and its safety and soundness should include (1) effective capital requirements, (2) government power to remove directors and management for cause, (3) a debt-to-asset limitation, (4) regulatory prior approval authority, and (5) general regulatory authority. S. 1929 provides for the last of these protections.

A. Capital requirements. Capital requirements help motivate management to confine risks because of the need to protect the shareholders' investment. Fannie Mae's charter imposes capital requirements in the form of a debt-to-capital ratio subject to HUD's regulatory control. A similar provision is found in the COSBI charter act Section 354(a).

However, two strengthening amendments are required to Section 354(a) if it is to be more than merely illusory in its effects. First, the COSBI bill appears to be drafted so that subordinated obligations issued under Section 354(b) are included in the computation of COSBI's capital and surplus. Yet, unlike shareholder capital, these subordinated obligations probably benefit from the government's implicit guarantee. That means COSBI can increase its nominal capitalization under the bill by issuing a virtually unlimited amount of these subordinated obligations, and then can leverage its other debt off of this base. As drafted, the 15-to-1 ratio is not a genuine limitation on COSBI or on the government's risk exposure.

To avoid this problem, the COSBI bill might specify that subordinated obligations do not count as capital for purposes of the debt-to-capital ratio of Section 354(a). Alternatively, the legislation might simply remove COSBI's authority to issue subordinated debt. The Corporation can issue a wide range of other securities to increase its capital, such as nonvoting common stock, preferred stock, and convertible and exchangeable debentures. Unlike the fully private firm without federal backing, there is no need for subordinated debt in COSBI's financial structure.

Second, note that the COSBI debt-to-capital ratio is drafted so it does not restrict the volume of COSBI's issuance and guarantee of loan-backed securities under Section 356. Yet, in contrast to the assets of some other government sponsored enterprises such as Sallie Mae, credit quality is a vital issue with the SBIC securities COSBI will deal in, and include in its loan-backed securities.[*]

Therefore, COSBI's leverage should be controlled by a ratio that applies to all securities that COSBI issues or guarantees. Such a ratio might be constructed simply by amending the language of Section 354(a) to establish a ratio of COSBI's capital to all obligations and securities the corporation issues or guarantees. This protective measure can help correct for the weakening of marketplace constraints that otherwise would limit COSBI's leverage, if the corporation were not implicitly backed by the federal government.

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[*] Since 1975, SBA has had to accelerate and pay off investors for over 18% of the amount of issued SBIC debentures and has liquidated 69 of the 300 issuing SBICs (23%). This kind of default rate implies substantial credit risk for COSBI in dealing with SBIC securities. "Offering Circular, $84,170,000, U.S. Small Business Administration Guaranteed 10.35% Participation Certificates, Series SBIC 1987-C," p. 10-11 (Sept. 23, 1987).

B. Management quality. The Fannie Mae charter act permits the President of the United States to remove Fannie Mae directors, including shareholder-elected directors, for cause. A similar provision is found in other enterprise charter acts. By contrast, the draft COSBI legislation permits removal for cause only of presidentially-appointed directors. The legislation should be corrected to permit removal for cause of all directors, and of top corporate officers, and preferably should be supplemented by report language from this Committee providing that justifiable cause for removal would exist when COSBI's net worth fell to some specified level.*/ Net worth should be measured on a market-value accounting basis, in keeping with recent moves to apply market value accounting to financial institutions and financial instruments. At the specified point, the regulator would be permitted (but not required) to remove directors and top management.

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*/ Financial institutions are most prone to take excessive risks when net worth is low. See, e.g., Marsha L. Stigum and Rene O. Branch, Jr., Managing Bank Assets and Liabilities, p. 194 (1983): "The time really to watch a bank management is when things are going badly. At some point management comes to the realization that they are going to lose either their jobs or, worse still, their bank unless they make a high-stake gamble and win. That stark reality - nothing to lose on a gamble and everything to win - is bound to dampen whatever natural risk aversion management may have."

C. Debt-to-asset limitation. The Fannie Mae charter act prohibits the enterprise from issuing debt if this would cause outstanding debt obligations to exceed its available assets. This provision is essential to compensate for the lack of market discipline inherent in enterprise operations. Without such a limitation, a government sponsored enterprise could continue to issue debt obligations and other securities implicitly backed by the federal government, even though it had become a commercial failure with a negative net worth. Again, this requirement should be applied on a market-value accounting basis.

D. Prior regulatory approval. Government sponsored enterprises are usually limited to specializing in a narrow line of business. Thus, Fannie Mae is limited to providing a secondary market for residential mortgages and COSBI may only deal in SBIC securities, rather being free to engage in the broader range of lending permitted to national banks, for example.

Within their confined markets, enterprises tend to become very large. As in the case of S. 1929, the enabling legislation for enterprises provides advantages few (if any) competitors can match. The implicit government guarantee and SEC exemption lower COSBI's borrowing costs, the enterprise is exempt from state and local income, sales and other taxes (except real property taxes), and COSBI loans are largely exempted from state usury laws. COSBI also has a benefit not granted to Fannie Mae or Freddie Mac: investor income from COSBI securities is exempt from state and local taxes.

Thus, COSBI has formidable competitive advantages likely to permit its growth to a very large size.*/

Because of this large potential size and statutory specialization, errors in the business operations of a government sponsored enterprise such as COSBI can amplify into large scale problems that cause no apparent harm until they suddenly precipitate a huge amount of financial damage. This happened, for example, with loans of the Farm Credit System (FCS) institutions, that suffered from problems of credit quality. It also happened with the FCS funding mismatch that significantly increased the interest-rate exposure of the system. This is also potentially true especially for credit risks from COSBI's operations, as the corporation purchases or guarantees SBIC securities.

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*/ The draft legislation weakens one significant potential constraint: the size of COSBI's permitted market. S. 1929 removes SBICs from SBA regulations designed to assure that SBIC borrowing advantages are actually channeled to the credit needs of small businesses. Without controls strictly enforced by an independent regulator, SBICs are increasingly apt to look for ways to channel their inexpensive federally-supported credit to a more broad category of borrowers beyond the small businesses they serve today.

As a means of prompting increased enterprise attention to reducing risks, regulatory prior approval is an important tool. Thus, the Fannie Mae charter act requires the regulator's prior approval of Fannie Mae programs to purchase and deal in various assets. Before engaging in a new loan-backed guaranteed security program under Section 356, for example, COSBI should be required to obtain regulatory approval of the program and of the means the corporation proposes to reduce risk exposure. While such regulatory approval does not guarantee that unnecessary risks will be avoided, it does provide an opportunity for independent review of the risks involved in any proposed program before operations actually begin.[*]

A second kind of prior approval authority found in the Fannie Mae Charter Act is also important, to give the federal government a way to regulate its risk exposure from COSBI activities. In the Fannie Mae charter act, a regulator's prior approval is required for the enterprise to issue mortgage-backed securities, debt obligations, subordinated obligations, and stock.[*] The COSBI charter act should include a Fannie Mae-type provision requiring that "All stock, obligations, securities, participations, guarantees, or other instruments issued pursuant to this title shall be issued only with the approval of the Administration."[**]

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[*] For the same reason, prior approval should also be required for COSBI activities under Sections 357(a), and (d) (establishment of appropriate criteria for small business investment companies to conduct business with the corporation), Section 358 (issuance of rules relating to the corporation's dealings with SBICs) and Section 359 (activities with respect to special small business investment companies).

Finally, the Fannie Mae charter act permits the regulator to approve the level of dividends paid by Fannie Mae to its shareholders. As an alternative, the COSBI charter act might prescribe that no dividends are to be paid at any point when COSBI's net worth fell below a prescribed level, again on a market-value basis.

E. General regulatory authority. S. 1929 is a stronger piece of legislation than other versions of the COSBI charter act because it contains this provision. Similarly, the Fannie Mae charter act provides that its regulator "shall have general regulatory power over the

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[*] Formerly, the Department of Housing and Urban Development (HUD) approved all such issuances; at some point the Fannie Mae charter was changed to delete HUD approval for securities whose issuance Treasury approves.

[**] Alternatively, prior approvals of issuance of COSBI securities could be inserted in Section 353(a) (issuance of common stock), Section 353(b) (issuance of non-voting preferred stock), Section 354(a) (issuance of debt obligations), Section 354(b) (issuance of subordinated obligations), Section 356(c) (issuance or guarantee of securities based on or secured by SBIC securities), and Section 359(c) (guarantee of special SBIC dentures).

Federal National Mortgage Association and shall make such rules and regulations as shall be necessary and proper to assure that the purposes of this title are accomplished." 12 U.S.C. § 1723a(h). This general regulatory authority is important to empower the regulator to fill in gaps in the otherwise sparse language of a federal charter act.*/

The general regulatory power, along with the prior approvals permitted to Fannie Mae's regulator, is also important to provide the regulator with leverage over the enterprise. The legislative history of Fannie Mae expressly spells out the need to give the regulator leverage so the corporation carries out the purposes of its charter act while protecting the federal government's financial exposure.**/ Such leverage is also inherent in the relationship of federal regulators to banks.***/ Especially if COSBI becomes a very large institution, its regulator must be able to exert subtle leverage rather than being forced to rely upon more draconian measures that could disrupt the financial markets.

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*/ In contrast to other corporations, government sponsored enterprises such as COSBI are chartered by a federal statute whose fairly rigid provisions must substitute for the more flexible combination of a state's corporation law and the company's own articles of incorporation.

**/ See, Senate Committee on Banking and Urban Affairs, Hearings: Housing and Urban Development Act of 1968, p. 60, Part I, Testimony of Robert C. Weaver, Secretary of Housing and Urban Development (1968).

***/ See, Carter H. Golembe and David S. Holland, Federal Regulation of Banking, 1986-1987, p. 231-2 (1986).

I would suggest one technical change to the present language of Section 360(h). That is to delete the requirement that SBA conduct a full-scale hearing for any COSBI regulations it issues. The regulatory process is cumbersome enough without mandating application of Sections 556 and 557 of the Administrative Procedures Act to every regulation or amendment.

F. Other statutory issues. I would be pleased to discuss other important technical matters with committee staff. Besides the statutory language of the COSBI bill, the committee would be well advised to scrutinize proposed report language especially to assure that it strengthens rather than contradicts the essential goal of protecting COSBI's long-term safety and soundness.*/

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*/ One provision of the COSBI bill deserves special mention. That is Section 6 of S. 1929. Section 6 provides that the company and its board of directors be permitted to exercise their powers and functions "without regard to any other law," except as Congress hereafter expressly provides. This appears to be a license to disregard the laws everyone else must obey, and arguably preempts a large variety of significant federal and even state statutes. This section raises a question whether COSBI is even subject to the criminal laws or to basic laws such as antitrust and securities antifraud requirements. Section 6 should be completely eliminated.

III. Regulation is especially important because COSBI is designed to be controlled by its users, the SBICs

Effective regulation is especially important if COSBI is structured to be controlled by its users. S. 1929 gives complete voting control over COSBI (nine out of 15 seats on the Board of Directors) to SBICs, rather than to a broad range of investors.*/ This structure creates distorted incentives for COSBI that can seriously decrease its financial viability, especially because the bill fails to provide for an effective independent regulator. Moreover, control of COSBI by a broad range of investors could better help motivate COSBI to serve the most important small business credit needs.

A. SBIC control compounds questions about COSBI's long-term safety and soundness. Take the potential costs first. User control seriously distorts COSBI's corporate incentives compared to the usual company controlled by a broad range of investor-shareholders. While general shareholders have some incentive to protect and enhance their investment in the company, user-shareholders have an incentive to grant themselves unusually favorable terms when they use its services, at the expense of the company.*/ For example, SBIC users of COSBI will be interested in doing a large and profitable volume of business with the enterprise, and will be less enthusiastic about COSBI constraints imposed to assure credit quality of the SBIC securities COSBI buys or guarantees.

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*/ This control is created as follows. Section 353(a)(5)(B) requires SBICs to retain their voting stock for at least three years after it is issued. However, SBIC control is likely to be permanent because Section 353(a)(4)(D) permits COSBI to issue new stock to SBICs each time they sell securities to COSBI. Given that COSBI's business is likely to expand, similar to the growth of other government sponsored enterprises, COSBI can issue an increasing volume of voting common stock to SBICs.

COSBI can adjust the amount of stock it issues to SBICs in a given year to exceed the amount of three-year old stock SBICs choose to sell to the public. Under the terms of S. 1929 SBICs are likely always to retain a control block of COSBI stock.

User control of COSBI raises questions of financial safety and soundness. The Farm Credit System is one government sponsored enterprise that was dominated by its users, much as COSBI has currently been designed to be controlled by the small business investment companies with whom it does business. The Farm Credit System failed to maintain its financial viability, in part because users persuaded the corporation to grant more favorable terms than could be justified on an arms-length financial basis.*/ The combination of user domination of COSBI, with omission of many regulatory and protective provisions found in the Fannie Mae charter act, does not bode well for COSBI's long-term financial viability.**/

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*/ A similar result is achieved by Section 356(c) (at p. 22, lines 4-7) of S. 1929 that restricts the interest rate spread, and thus the price COSBI may charge for its guaranteed securities. This restriction permits the benefits of COSBI's guarantee to be captured by the SBIC whose securities COSBI guarantees. This provision should be eliminated to permit COSBI to build up a capital base to help protect its long-term viability.

B. SBIC control makes it difficult to target COSBI's benefits to the most important credit needs of small business. Now consider the impact on the distribution of COSBI's benefits. There is an important distinction between borrower control of FCS institutions and SBIC control of COSBI. In the FCS case, the benefits of favorable loan rates went directly to the ultimate farm borrowers. For COSBI, it is not clear how much of the benefit will be passed on to small business borrowers. If permitted, SBICs will have an incentive to channel their profitable business to large as well as small companies.

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*/ See, e.g., The U.S. General Accounting Office, Farm Credit System: Analysis of Financial Condition, (1986).

**/ Note that Section 357(a) makes COSBI especially vulnerable to loss because it grandfathers existing SBICs and deems them qualified regardless of their actual financial condition. This would preclude the Corporation from disqualifying financially unqualified SBICs from doing business with the Corporation. Section 357(a) must be rewritten to require COSBI to disqualify unqualified SBICs and to require requalification of SBICs at frequent intervals to assure that they are financially capable of originating and servicing loans for COSBI.

S. 1929 removes SBA regulations (in 13 C.F.R. § 107) that are intended to assure that SBICs actually channel to small businesses the benefits of their federally-supported credit. Instead, regulation of SBICs is left to COSBI which, in turn, is structured to be legally controlled by SBICs. Such regulation is unlikely to be strict. Especially if new loan opportunities (say, to larger businesses) promise to be lucrative, SBICs will have an incentive to look for ways around today's restrictions that confine SBICs to lending only to small companies. This bill lacks an independent regulator capable of policing COSBI's federally-supported credit to assure that it flows only to small businesses. Absent such a regulator, the SBICs that own and control COSBI will have little incentive to permit COSBI to interfere with SBIC lending activities.

Finally, this committee later may want to expand COSBI's power to provide other support for small businesses, beyond SBIC-related financing. For such purposes, the Fannie Mae structure is again far preferable. Investor-shareholders of a profit-motivated enterprise may be much more willing to expand their activities to provide a broad range of non-SBIC services to the small business community than are the controlling shareholders of COSBI under S. 1929, who will have their primary loyalty to promoting the functions of small business investment companies.

C. Publicly-appointed directors are unlikely to increase public control. The proposed COSBI legislation provides for a minority of corporate directors to be appointed by the President and confirmed by the Senate. Such governmentally-appointed directors are unlikely to add to the public control of COSBI, or to the Corporation's safety and soundness. Enterprises can turn to devices such as corporate stock options for directors to help reinforce the identification of all directors, including governmentally-appointed directors, with the interests of enterprise shareholders. A panel of the National Academy of Public Administration has argued that governmentally-appointed members should not be included on the boards of government sponsored enterprises or other federally chartered corporations.*/

If this Committee does desire that the COSBI board include publicly appointed directors, the Fannie Mae charter act is again useful as a guide. The Fannie Mae Board consists of five presidentially-appointed directors on an

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*/ National Academy of Public Administration, Report on Government Corporations, p. 33, (1981). There is substantial evidence from the performance of government corporations that governmentally-appointed directors do not add to public control. See Herman Schwartz, "Governmentally Appointed Directors in a Private Corporation - the Communications Satellite Act of 1962," Harvard Law Review, pp. 350-364, (1965).

18-member board. The statute specifies that three of those five directors shall be appointed from designated industries -- homebuilders, mortgage lending, and real estate -- with a special stake in Fannie Mae activities.

Thus, presidentially-appointed directors can provide representation on the corporate board of directors for constituencies whose voice Congress wishes to promote. A stronger structure for COSBI would be to amend S. 1929 to provide for a Fannie Mae-type structure and a profit-motivated enterprise with publicly-traded voting common stock and with common stockholders electing the majority of COSBI directors. The one-third minority of presidentially-appointed directors (preferably without the cumbersome requirement for Senate confirmation) could then be required to include appointments from the small business community generally, and from SBICs and special SBICs, as this Committee sees fit.

IV. Conclusion

This Committee is to be commended for considering a variety of ways to serve small businesses without running afoul of today's severe budget constraints. Creation of a government sponsored enterprise is one way -- outside of the formal budget process -- to provide financial assistance to the small business community. However, as presently structured the COSBI charter legislation fails to promote the corporation's long-term viability or the corporation's direction of its substantial federal, state and local benefits to meeting the highest priority needs of the small business community. The committee has provided for general regulatory oversight. However it is essential that other protective provisions be added as well. Along with the structuring of the corporation to be controlled by investors besides SBIC users of COSBI services, this will go a long way to making the corporation a credit to this Committee and to American small business.

* * * * *

Attachment: Thomas H. Stanton, "Pending Legislation Would End Impasse Over SBA Program: Congress May Create a New Corporation to Aid Small Business, But Has Drafted the Law in a Way That May Ultimately Expose the Government to Significant Legal Losses," Legal Times, October 6, 1986, p. 24.

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Law And Lobbying In The Nation's Capital

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ANALYSIS

Pending Legislation Would End Impasse Over SBA Program

Congress may create a new corporation to aid small business, but has drafted the law in a way that may ultimately expose the government to significant financial losses.

BY THOMAS STANTON

Hidden in House bill H.R. 5300, the Omnibus Budget Reconciliation Act of 1986, is legislation to create the Corporation for Small Business Investment (COSBI). The corporation, designed to allocate credit to small business on favorable terms, would be capitalized from the sale of stock to small business investment companies (SBICs) and boosted by purchase of federally guaranteed Small Business Administration (SBA) assets at a favorable price.

COSBI would pay $850 million for assets valued at about $1.1 billion, giving the corporation an initial capitalization of $250 million.[1]

The creation of COSBI would resolve an impasse between the administration, which has sought to zero out the entire SBIC program, and the small business community, which has successfully resisted. The tug-of-war over the past six years has cast uncertainty over the future of SBA programs, restricted available funds, and even forced SBA to close its loan windows on several occasions.

The creation of COSBI would permit the federal government to provide substantial advantages in funding SBIC securities, without actually committing appropriated funds after the initial sale of assets.

The COSBI model is an enticing alternative for other direct credit programs now feeling federal fiscal pressure; after the initial capitalization, the federal government continues to support a favored economic sector without spending scarce appropriated funds. Federal maritime or export loans, for example, might lend themselves to the COSBI model, instead of current Maritime Administration or Ex-Im Bank programs.

In analyzing a program such as COSBI, which is backed by a perceived special federal relationship, the charter legislation must be carefully drafted to limit the government's exposure to substantial financial losses while assuring the new corporation's dedication to intended public purposes. Within this framework, the COSBI legislation is structured to maximize business opportunities for dealing in small business investment securities while minimizing government regulatory control.

Compared with other government-sponsored enterprises (GSEs), Treasury regulatory authority over COSBI is circumscribed, and COSBI is free from intervention by any other regulator. Under prudent management, as the House committee report urges upon the corporation, COSBI will do well.

Under less prudent management, however, COSBI invites financial difficulty followed by belated federal efforts to impose strong regulation. (This occurred last year with the Farm Credit System.) At press time, the Senate conferees appeared to be addressing some of these concerns. COSBI is likely to emerge, however, in approximately the format analyzed here, albeit with a lower initial capitalization from the SBA asset sales.

COSBI is based on the model of five GSEs that are currently directing funds to selected sectors of the economy. They are the Federal Home Loan Banks; Federal Home Loan Mortgage Corporation (Freddie Mac); Federal National Mortgage Association (Fannie Mae); Student Loan Marketing Association (Sallie Mae); and the Farm Credit System (composed of Banks for Cooperatives, Federal Intermediate Credit Banks, and Federal Land Banks).

Because they are privately owned, these institutions are not included in the federal budget. By law, their debt obligations (and some other securities) clearly state that they are not guaranteed by the United States.

Despite this explicit disclaimer, the financial markets perceive a special relationship between GSEs and the federal government. Thanks to this perception, GSEs sell their debt obligations at more favorable rates than can commercial companies without the perceived relationship.

Because the borrowing costs of these enterprises are lower, they can purchase assets (student loans, farm mortgages, home mortgages) bearing lower rates of interest. The intended result is lower borrowing costs for students, farmers, and homeowners than would otherwise be the case.

While the implicit subsidy is not as substantial as when loans are funded directly by Treasury borrowing, as they are currently in the SBIC program, it is a significant benefit nevertheless.[2]

In addition, the COSBI charter act is drafted to provide COSBI an exemption from state and local taxes—except for property taxes—to exempt COSBI obligations (i.e., interest income on those obligations) from state and local taxes, and to provide other benefits accorded some of the GSEs.

Several statutory characteristics, varying somewhat among the five GSEs, lead the market to perceive the special federal relationship. COSBI creates this perception with the following features (relevant charter act sections are noted in parentheses):

1) COSBI is federally chartered with presidential appointment of one-third of its 15-member board of directors. The remaining directors are elected by shareholders (§352(d)).

2) COSBI obligations may be issued only upon approval of the Secretary of the Treasury (§354(a)).[3]

3) All COSBI stock and obligations are exempt from regulation by the Securities and Exchange Commission to the same extent as U.S. government securities (§355).

4) COSBI obligations, preferred stock, and guaranteed securities are lawful investments for fiduciary, trust, and public funds; are eligible to be bought and sold in Federal Reserve open market operations; are legal investments to satisfy reserve requirements of banks and thrift institutions; and are deemed U.S. agency obligations for purposes of Bankruptcy Code provisions relating to repurchase agreements (COSBI §355 and §9009 of H.R. 5300).

5) COSBI obligations are exempt from state and local taxation (§355). This is a substantial benefit not afforded to Fannie Mae and Freddie Mac.

6) The secretary of the treasury is permitted to purchase up to $500 million in COSBI obligations. With variations, such a so-called backstop authority is common to virtually all GSEs. In contrast to other GSE charters, the COSBI legislation provides that funds for this Treasury backstop must be appropriated in advance by the Congress (§354(c)).

By conferring on COSBI stock and obligations the same preferred investment status as U.S. Treasury obligations, the federal government makes a strong statement to investors. The exemption from SEC laws removes investor protections considered necessary for all but the most secure—i.e., federally backed—securities.

Similarly, the exemption from investment restrictions on banks and thrift institutions is otherwise limited to federally backed securities. Investors perceive that the federal government would not permit these exemptions from basic investor protection unless the securities were extremely safe.

Over time, the market can become even more confident about the government's likelihood of backing obligations of GSEs. At the beginning of this year, GSEs had more than $350 billion in debt obligations outstanding. The government would be unlikely to permit any one of these institutions to default on its obligations for fear of shaking investor confidence in *all* GSE obligations and potentially causing the price of more than one-third of a trillion dollars in such securities to plummet.

Thus, while borrowing costs did rise somewhat for the Farm Credit System during the financially troubled period leading up to the 1985 remedial legislation, yields on farm credit securities remained significantly below yields on A-rated private corporate bonds.[4] In other words, investors look primarily to the implicit federal backing as a guarantee of GSE creditworthiness. As the value of outstanding GSE obligations increases, so does the inability of the federal government to intimate that it would not stand behind this debt.

In summary, then, COSBI represents a true compromise position between an administration that seeks to end all support for SBICs and the small business community now accustomed to receiving federally guaranteed funds to support small business investment.

Minimizing Risks to Taxpayers

The contingent liability of the federal government has increased sharply over the past decade because of the increasing volume of outstanding GSE debt. To assure that the public is protected against the need to bail out a failing GSE, a course that some suggest is now necessary with the Farm Credit System, each one must be carefully structured and regulated. When one looks at the technical language of the COSBI charter legislation, significant questions arise.

Consider the extent of potential public exposure. Because the market essentially looks to the federal government to assure creditworthiness of outstanding GSE debt, GSEs can afford to issue high amounts of debt relative to their equity capital.

Under the House bill, COSBI would have an initial capitalization of about $250 million from its favorable purchase of SBA assets. COSBI is statutorily committed (§361(a)) to placing $100 million of this in a trust to subsidize special SBICs, those owned by socially or economically disadvantaged entrepreneurs. This leaves $150 million as start-up capital, plus $15 million in an initial offering of common stock (§352(d)).

Since the perceived federal relationship gives GSEs the opportunity to achieve very high debt-to-capital ratios—for example, at the start of the year, Fannie Mae stood at about a 70-1 ratio of debt to shareholder equity—COSBI could eventually issue billions of dollars in obligations, plus additional debt leveraged from stock issued after the initial offering. This could amount to several times the current SBIC assets outstanding. Indeed, because of COSBI's additional authority to guarantee securities, the potential public exposure could be immense.[5]

Compared with other GSE charter acts, the COSBI charter fails to include a number of protections that would limit this huge potential public exposure. In particular, COSBI lacks internal and regulatory controls familiar from the other charter acts.[6]

1) There is no statutory or regulatory limit on COSBI's debt-to-capital ratio; there is also no statutory requirement that COSBI refrain from issuing debt in excess of its assets.

2) There is no statutory or regulatory limit on the quality of assets COSBI may purchase; under the broad definition of "small business investment securities," COSBI is allowed to buy stock, warrants, and even junk bonds of small business investment companies, virtually without statutory limitation as to the credit quality of the asset.[7]

3) COSBI is structured so that the board of directors is likely to represent the interests of COSBI's loan customers. The House committee report (page 384) makes this explicit: "The Committee expects elected members of COSBI's Board will be experienced SBIC professionals and leaders in the industry." This was a problem for the Farm Credit System. It is hard for representatives of borrowers, unless fortified by tough statutory requirements and regulatory enforcement, to turn down loans to their less creditworthy peers.

4) COSBI's regulator is a toothless watchdog. Indeed, the Small Business Administration has no formal regulatory authority over COSBI at all. Instead, SBA is given mere "review authority" (§360(a)), with power to examine the corporation's books and records, and to require the corporation to make reports.[8] Additionally, the Secretary of the Treasury may inspect the corporation's books, verify transactions, and receive an independent audit of the corporation's accounts.

The absence of more systematic regulatory control places COSBI under more lax supervision than most of the other GSEs, with the possible exception of Sallie Mae, and under substantially less supervision than the federal government provides for banks and thrift institutions. Finally, unlike some GSE charters, the President has no power to remove shareholder-elected COSBI directors, even for cause. With its weak regulatory framework, COSBI is inviting financial instability followed by future strong regulation such as Congress belatedly imposed upon the Farm Credit System in 1985.

Besides the public loss exposure, there is the question of COSBI's public purpose. GSEs are intended to serve public purposes. Fannie Mae and Freddie Mac are limited to making a secondary market in mortgages on homes below a certain mortgage limit; Sallie Mae is limited to purchasing student loans whose terms, including loan size, are largely dictated by other governmental programs.

By contrast, COSBI is virtually unlimited in the size or type of SBIC security in which it may deal (§356). While the structure of COSBI's activities to further its public purpose depends upon careful economic analysis, some statutory criteria beyond the limitations in the current COSBI charter legislation would seem to be in order.

GSEs have many advantages as a tool of federal policy. They have successfully overcome market imperfections, allocating credit to such special sectors of the economy as housing, farming, and education.

Over the years, Fannie Mae has helped standardize the previously regionalized and overly fragmented residential mortgage market. The Farm Credit System made a market in farm loans that commercial banks were unwilling to make. Sallie Mae has greatly increased the supply of student loan funds. Significantly, GSEs allocate credit without drawing on federally appropriated funds.

But there is no free lunch. Like Continental Illinois Bank and other large financial institutions, GSEs are too big for the federal government to permit a failure. That means that the chance of failure must be reduced, both in the enabling legislation and in careful regulation and oversight.

This is not to say that past regulation has been ideal. HUD's zealous attempt to regulate Fannie Mae's mortgage purchases in the late 1970s led to virtually no positive results.[9] The Farm Credit Administration lost its independence regulating the banks of the Farm Credit System.[10] But COSBI goes too far in excluding itself from regulatory oversight (except for the limited Treasury approval power needed to assure market perception of a special federal relationship). Beyond mere review authority, an independent regulator must be able to intervene to prevent catastrophe. The House committee report (page 387) completely glosses over this problem:

> From the regulatory perspective, the professional industry leadership

> elected to COSBI's Board of Directors should do a far better job of regulating business practices of SBIC's than government regulators. The knowledge and awareness of these professional SBIC managers and the self-interest in keeping the industry free from abusive practices should create a tremendous incentive for consistent and diligent oversight and strong enforcement of proper business practices.

Maybe so, but financial institutions, including GSEs, are too large and too vulnerable today to permit such intentions to stand unsupported by a carefully designed regulatory structure.

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[1] The Congressional Budget Office says that the entire $250 million would count against federal budget targets for purposes of Gramm-Rudman. In addition, other SBA assets would be used to further support special SBICs, assisting disadvantaged entrepreneurs. House Comm. on the Budget, *Report: Omnibus Reconciliation Act of 1986*, H.R. Rep. No. 727, 99th Cong., 2d Sess., at 398-399 (July 31, 1986) [hereinafter *House committee report*].

[2] *See, e.g.* Congressional Budget Office, *Government-Sponsored Enterprises and Their Implicit Federal Subsidy: The Case of Sallie Mae*, ch. 3 (Dec. 1985); General Accounting Office, *The Federal National Mortgage Association in a Changing Economic Environment*, at A-80 to A-85 (Apr. 15, 1985); Moran, *The Federally Sponsored Agencies: An Overview*, Fed. Reserve Bull., June 1985, at 373-88.

[3] Unlike other GSEs, this regulatory authority has been carefully drafted to limit Treasury to approving time of issuance, rate of interest, and other terms and conditions (and not, for example, the volume of securities issued). Also, Treasury has no approval authority over issuance of subordinated debt or COSBI guaranteed securities. (§353, §354(b), and §356(c)).

[4] Office of Management and Budget, *FY 1987 Special Analysis of the Budget of the United States Government*, Special Analysis F, "Federal Credit Programs," at F-27 to F-28 (1986).

[5] One question is whether the market will accord these COSBI-guaranteed securities the perception of federal backing. In contrast to guaranteed securities of other GSEs, the COSBI legislation does not exempt such COSBI securities from SEC regulation and does not require that they be approved by the Treasury.

[6] The Sallie Mae charter is closest to the COSBI legislation in this regard. Yet Sallie Mae's board of directors is statutorily required to be more diversified than COSBI's; more important, Sallie Mae's portfolio consists almost entirely of student loans guaranteed by others, rather than COSBI's inherently more risky portfolio of SBIC paper.

[7] Although COSBI is required to set criteria for SBICs with which it does business, the statutory language is permissive rather than mandatory. "Such criteria *may* include, among other things, the general business reputation and character of the owners and management . . . and the probability of successfully operations, . . . including adequate profitability and financial soundness." §357(a) (emphasis added).

[8] The COSBI charter act also expressly removes current SBA regulatory authority over SBICs. *House committee report*, at 375-76, 387-89.

[9] *See, e.g.*, General Accounting Office, *Symposium: The Federal National Mortgage Association in a Changing Economic Environment*, at 233 (1985).

[10] *See, e.g.*, Farm Credit Amendments Act, Pub. L. No. 99-205, 99 Stat. 1678 (1985); Agriculture Comm., H.R. Rep. No. 425, 99th Cong., at 11-13 (1985). ☐

Senator WEICKER. Thank you very much, Mr. Stanton. Mr. Murray.

STATEMENT OF JAMES E. MURRAY, ATTORNEY, BROWN & WOOD, WASHINGTON, DC

Mr. MURRAY. Thank you, Mr. Chairman, for the opportunity to testify today. My background is I was general counsel of Fannie Mae for about 11 years and president of Fannie Mae for two years. I helped to draft the Sally Mae legislation and implement that legislation. Most recently I drafted the Federal Agricultural Mortgage Corporation title of the Agricultural Credit Act which was just signed by the President on January 6.

This is a sidelight, Mr. Chairman: In the hearings on Farmer Mac, Mr. Sethness testified at great length, and it is interesting that in his opposition to Farmer Mac, in addition to the comments he made this morning, was that Farmer Mac was going to be too efficient, that a secondary market in agricultural real estate loans really would be too efficient a way of raising capital for farmers.

His citation, Mr. Stanton's citation of the problems of the Farm Credit System and the Home Loan Bank System are especially ironic because I think they illustrate why COSBI is needed for small business investment companies. These systems are creatures of the New Deal, and they have encountered the problem that they just have become anachronisms in the kind of financial structure that we have in this country today.

Looking back historically, COSBI is based upon the model of the First Bank of the United States, which was chartered by the Congress. 20 percent of the stock was owned by the Federal Government, and 80 percent was owned by private shareholders. The President appointed five directors and the shareholders elected 20, and the relationship of this kind of a Government-sponsored corporation in the Federal Government was addressed by Alexander Hamilton when he stated that a corporation in order to be successful, has to be privately managed by its shareholders, and he strictly urged that that be done in the case of the First Bank. COSBI essentially is chartered based upon that model as was Fannie Mae and the other corporations. Sally Mae was based upon the model of the First Bank of the United States.

As attached as exhibits to my statement I give you charts of all of the other Government-sponsored corporations and have listed the various characteristics of those corporations and how COSBI compares, and I think COSBI in many respects is much more heavily regulated in S. 1929 than those other corporations are.

The reasons for COSBI are that it is more effective. It is a more effective way of providing funds for small business. It brings in additional capital. Take a look at the housing market. Fannie Mae and Freddie Mac, the secondary markets, are providing more than two-thirds of all of the funds for housing, in 1986–1987 and going forward in the future. The Home Loan Bank System, which provided two-thirds of the funds for housing, 5 years ago, provides virtually little in the way of new funds for housing today. Housing would be a complete disaster. Rather than a recession, I think this country would be faced with a major depression if it were not for the secondary market in residential home mortgages.

Mr. Stanton cites the Fannie Mae experience in that the Fannie Mae experience is the most direct experience. The Banking Committees were faced with the same problem, I think that this Committee has, Mr. Chairman. They wanted to make Fannie Mae a private corporation, but they weren't quite sure how the public interest would be protected. So they put a provision in the Fannie Mae Charter Act which essentially called for general regulatory authority and no one really knew what that meant until 1978 when the Secretary of HUD published regulations which would have required that Fannie Mae invest about 30 percent of its funds in central cities. We pointed out to the Secretary of HUD that only about 20 percent of the transactions in housing were in the central city. There was a general public outcry. The HUD regulations would have imposed HUD's discretion on any management decision that was made by a corporation. Of course, because it was important, the home builders, the realtors, the mortgage bankers objected, and when the final regulations were adopted by HUD, the Secretary of HUD retreated from that position and took the position that the Secretary only would exercise that authority where it had specific authority in a specific area and would not attempt to use the general regulatory authority.

I think what concerns the SBIC industry is that if that kind of general authority is given to SBA that it would be an invitation for SBA to do the same thing, to come back and try to run the day-today operations of COSBI. S. 1929 in my opinion has more than adequate provision to protect the Government interests. There are audits, reports that have to be made to the Congress, and Congress certainly will have oversight authority. That will be more than sufficient in the case of corporations like Fannie Mae. Congress will make its views known, and the corporation is going to be very receptive to those views.

The experience of Sally Mae has been that they have had much less regulation than S. 1929 would provide in the case of COSBI, and Sally Mae has been operated in a very effective way, has provided billions of dollars for student loans and has had virtually little regulatory authority on the part of the Department of Education.

Mr. Stanton's arguments for greater regulation are based upon, I think, a false premise. The SBIC industry's private capital is at stake here. They really have a huge stake in making COSBI work, so I think that the Government interests, the Government investment, will only be after the SBIC industry capital has been spent.

The experience of Fannie Mae and HUD with general regulatory authority kind of language just doesn't work. Certainly the experience of the Farm Credit System and the Home Loan Bank System cannot be used as arguing against COSBI. I think those are excellent arguments why COSBI should be given a reasonable amount of regulation, specific regulation by SBA, but not an ambiguous grant of regulation that will only lead to conflict between COSBI and SBA.

Mr. Chairman, those are my remarks. I would be glad to answer any questions that you have.

[The prepared statement of Mr. Murray follows:]

STATEMENT OF

JAMES E MURRAY

ON

THE CORPORATION FOR SMALL BUSINESS INVESTMENT
(S. 1929)

PRESENTED TO

THE COMMITTEE ON SMALL BUSINESS

UNITED STATES SENATE

March 31, 1988

SUMMARY

In its deliberations on S. 1929 a critical issue for the Committee to consider is the extent of regulation by the Federal Government over the government-sponsored corporation proposed to be created by S. 1929, the Corporation for Small Business Investment ("COSBI"). As a former general counsel and president of the Federal National Mortgage Association ("FNMA"), I would like to share with the Committee the benefit of my experience on this subject.

If COSBI is to be owned and controlled by its shareholders, it must be truly a private corporation. If it is controlled by the Federal Government, through the guise of regulation, it will not be able to operate as a private corporation. COSBI is based upon the model of the First Bank of the United States, proposed by Alexander Hamilton to the Congress in 1791. Hamilton properly addressed the issue of the involvement of the Federal Government in the affairs of a government-sponsored corporation when he stated: "to attach full confidence to an institution of this nature, it appears to be an essential ingredient in its structure that it should be under a private, not a public direction --" (emphasis his).

Clearly, COSBI will be more effective in serving the interest of the small business community than SBA has been in the public sector:

- COSBI will be more efficient and effective than SBA as a private corporation, owned and controlled by its stockholders, based on the precedents of FNMA, FHLMC and SLMA.

- COSBI will attract additional capital to small business investments, as has been the case of the secondary markets in residential mortgages.

- COSBI will be able to adapt to rapidly changing financial markets, but only if it is not subject to undue federal regulations.

- COSBI will be self-sustaining. To be self-sustaining, it must be profitable and able to attract additional capital.

The experience of FNMA has been that the grant of a broad "general regulatory authority", which was given to HUD over FNMA did not work effectively. In 1978, HUD attempted to promulgate broad regulations which would have directed the mortgage investments of FNMA and involved the Department of HUD in the day-to-day activities of FNMA. The objectionable portions of the regulations were eliminated because of the great negative public reaction and the threat of litigation by FNMA.

There have been criticisms of S. 1929 and efforts to give SBA greater regulatory authority over COSBI. Such changes to S. 1929 would give the SBA effective control over the operations of COSBI. Broad regulatory authority would defeat the very purpose of the legislation which is to make COSBI a more efficient and effective vehicle for small business investments as a corporation operating in the private sector under the control of its shareholders.

The real issue is whether S. 1929 provides a regulatory system which will be sufficient to protect the interests of the government and to carry out the purposes of the Act. S. 1929 more than adequately provides for the protection of the government's interest.

- The Bill adopts SBA's regulatory criteria for qualification of SBIC's funding of small business concerns.
- Investments that are contrary to the purpose of the SBIC program are restricted.
- Regulations defining qualified small business concerns is codified.
- Restrictions are imposed on the maximum investment in any small business concern by an SBIC.

- Requirements are established for conflict of interest regulations.

- SBIC's are required to have private capital of $1 million.

- All COSBI borrowings are subject to approval by the Secretary of Treasury.

- Audits will be conducted by independent auditors of COSBI and the reports of those audits will be furnished to the Secretary of Treasury.

- Congress will receive timely information concerning COSBI's operations through annual reports by COSBI which must be furnished to this Committee and House Small Business Committee.

- The General Accounting Office will have full access to COSBI's books and records and will make a report to the Congress on COSBI's activities by January 31, 1993.

- SBA will be authorized to examine the books and records of COSBI and will be provided annual reports by COSBI.

- Five members of COSBI's Board of Directors will be appointed by the President.

The grant of a broad authority to the SBA in Section 306(h) of S. 1929 to "...adopt rules and regulations as shall be necessary" to carry out the purposes of the COSBI Act would be an invitation for SBA to run the affairs of the Corporation. Such a provision would be incompatible with the goal of COSBI to carry out its activities in the pursuit of national interests in the private sector as a self-sustaining corporation in the most efficient and effective way. That provision should be deleted from S. 1929.

In order to be able to accomplish its public purpose COSBI must be self-sustaining. To be self-sustaining it must be profitable and provide a return on the equity furnished by its shareholders, the SBICs. It is important to remember that in the first instance it is not only the capital furnished COSBI by the SBICs but the entire $1.5 billion capital of the SBIC industry that is at stake. This provides an overwhelming incentive for COSBI to be managed prudently and well. No amount of federal regulation or control can replace sound management of the government-sponsored corporation which is responsive to the needs of the market and serves the public purpose for which it was created.

STATEMENT

Mr. Chairman and Members of the Senate Committee on Small Business:

Thank you for the invitation to appear before this Committee and to submit a statement on S. 1929,[1] a bill to create the Corporation for Small Business Investment ("COSBI"). I am James E. Murray, a partner in the Washington, D.C. office of the law firm of Brown & Wood.

My background in government-sponsored corporations, particularly those engaged in secondary market activities, is as follows. From May, 1970 until May, 1981, I served as Vice President (and later Senior Vice President) and General Counsel of the Federal National Mortgage Association ("Fannie Mae"). From May, 1981, until January, 1983, I was President of Fannie Mae.

During 1971 and 1972, I assisted the Student Loan Marketing Association ("Sallie Mae") in the formulation and implementation of the legislation which created Sallie Mae.

I recently represented the American Bankers Association in seeking the creation of an agricultural mortgage loan secondary market. This effort culminated in legislation enacted in the last session of Congress. On January 6, 1988, President Reagan signed the Agricultural Credit Act of 1987.[2] Title VII of that Act created the Federal Agricultural Mortgage Corporation ("Farmer Mac") which is charged with the task of creating a secondary market for agricultural real estate loans. Lastly, I have served as special counsel to the National Association of Small Business Investment Companies ("NASBIC") and the American Association of Minority Enterprise Small Business Investment Companies ("AAMESBIC") with respect to the development of the COSBI legislation, which this Committee is presently considering in the form of S. 1929.

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[1] S. 1929, 100th Cong., 1st Sess., 133 CONG. REC. S17437-40 (1987)

[2] Agricultural Credit Act of 1987, Pub. L. No. 100-233, 101 Stat. 1568

Mr. Chairman, an extremely important issue for this Committee to consider is the nature of the relationship between the Federal Government and the government-sponsored corporation proposed to be created by S. 1929, COSBI. This is a subject on which I have had a great deal of experience during my years at Fannie Mae and I will share with the Committee my views and insights, based on that experience.

The History of Government-sponsored Corporations

Preliminarily, I believe it is useful to examine what historical antecedents and precedents there are for COSBI. The history of government-sponsored corporations dates back to the early years of the Republic. At the urging of then Secretary of the Treasury, Alexander Hamilton, Congress granted a charter to the First Bank of the United States in 1791. The chartering of the bank was over the determined opposition of Thomas Jefferson, based on his view that the Constitution did not give the newly-formed national government the power to create such federal corporations. The charter of the First Bank established it as a private institution, with 20 percent of its stock owned by the Federal Government and five of its twenty-five directors appointed by the President. The remainder of the stock was owned by the public and the stockholders elected twenty of the directors of the bank.

Secretary Hamilton was the first to address the issue of the nature of the relationship of the Federal Government to government-sponsored corporations:

> "to attach full confidence to an institution of this nature, it appears to be an essential ingredient in its structure that it shall be under a private, not a public direction --." (Emphasis his)

He went on to say that any suspicion that the nationally-chartered bank was "too much influenced by public necessity" would be a "canker that would continually corrode the vitals of the credit of the bank... the keen, steady, and as it were, magnetic sense of their own interests as proprietors, in the directions of the bank, pointing invariably to its true pole -- the prosperity of the institution -- is the only security that can always be relied on for a careful and prudent administration" and for "permanent confidence" in the bank. In 1819, the United States Supreme Court decided, in McCullock v. Maryland[3/], that the chartering of the First Bank of the United States was within the Constitutional powers of the United States Congress.

The charter of the Second Bank of the United States expired in 1836. From that time until 1913, when the Federal Reserve System was established, the country was without a central bank. Although

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[3/] McCullock v. Maryland, 17 U.S. 315 (1819).

the Federal Reserve System was chartered in a different form than the First and Second Banks, Congress maintained in the structure of the Federal Reserve System the independence enjoyed by the First and Second Banks of the United States. This independent structure has been preserved to this date, despite periodic efforts to impose Congressional or Executive restrictions on the independence of the Federal Reserve System's monetary activities.

The Government-sponsored Corporations in the Secondary Markets

Turning to the existing government-sponsored, secondary market corporations, enclosed as exhibits A and B to my statement are two charts which compare the legal and organizational characteristics of the government-sponsored secondary market corporations and the COSBI, as envisioned by S. 1929. The charts illustrate that the legal and organizational characteristics, and the relationships of COSBI to the Federal Government, are well within the norms established by the other government-sponsored corporations.

Purposes of the Government-sponsored Corporations in the Secondary Market

First, I will discuss the reasons why Congress has chartered these institutions in the private sector. Second, I will give some fundamental principles by which these corporations must be guided. Third, I will comment on certain criticisms of S. 1929.

COSBI Will Be More Efficient and Effective than SBA

The government-sponsored corporations engaged in secondary market activities have been created by the Congress to carry out activities determined to be in the national interest in the private sector. Whether in housing through Fannie Mae, Ginnie Mae and Freddie Mac; student loans through Sallie Mae; or farming through Farmer Mac, the United States Congress has made the policy decision that these corporations' activities in the secondary market can more properly be performed as private corporations, owned and controlled by their stockholders. Clearly, the same determination must be made in the case of COSBI. This legislation must be premised upon a decision by the Congress that it would be a significant improvement to the condition of the small business community to transfer certain of the activities performed by the Small Business Administration into the private sector.

Additional Capital Attracted to Small Business Investments

One of the primary reasons for creating government-sponsored corporations in secondary markets is to provide additional liquidity and attract new capital into a particular segment of the economy. This has been abundantly proven to be the case in the residential mortgage and the student loan markets.

Greater Ability to Adapt to Changing Financial Markets

In recent years, the financial markets have undergone significant changes. The methods of providing capital for housing, for example, have changed dramatically as the institutions of the Federal Home Loan Bank System have experienced financial difficulties. The government-sponsored corporations in the secondary markets have demonstrated an ability to adapt rapidly to changes in the primary markets. As private corporations, without undue government regulation, they have been permitted to move expeditiously to accommodate these changes.

Self-sustaining and Profitable

Government-sponsored corporations must be self-sustaining, which means that they must be profitable and able to obtain and attract new capital. In order to be self-sustaining, the government-sponsored corporations must operate in the private sector in the most efficient manner possible to obtain the return on capital sufficient to maintain and attract additional capital.

The Regulatory Experience of Fannie Mae

The best example of the uncertainties and difficulties resulting from excessive attempts by the Federal Government to control a government-sponsored corporation is the experience of Fannie Mae. During 1978, this relationship was severely tested by HUD regulations designed to exercise broad regulatory authority over Fannie Mae's mortgage activities in the secondary market. A careful review of that experience will be useful to the Committee in considering the appropriate regulatory relationship between SBA and COSBI.

Fannie Mae was created by the Reconstruction Finance Corporation on February 10, 1983.[4] Title III of the National Housing Act of 1954[5] rechartered Fannie Mae as a government-sponsored corporation which was intended to be financed by private capital to the maximum extent feasible. With progressively decreasing dependence on Federal Government financing, the expectation was that the secondary market operations of Fannie Mae would ultimately be transformed into an organization that would be wholly privately financed and operated. The 1968 Housing and Urban Development Act[6] established Fannie Mae as a stockholder-owned corporation after a prescribed transition period (which ended in 1970) which would maintain the secondary market operations of Fannie Mae. The Government National Mortgage Association, which was to be a wholly government-owned corporation, retained the governmental functions of the old Fannie Mae.

The legislative history of the 1968 Fannie Mae Charter Act[7] stated: "After a transitional period... [Fannie Mae's] common stockholders would control the board of directors" and that the shareholder-controlled Board would have "full power and responsibility for the policies of the Corporation..."

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[4] The original charter, issued by the Federal Housing Administrator, was under the name "National Mortgage Association of Washington." On April 1, 1938, the name was changed to "Federal national Mortgage Association."

[5] Title III of National Housing Act, 12 U.S.C. §1716 Et seq.

[6] Housing and Urban Development Act of 1968, Pub. L. No. 90-448, 82 Stat. 476

[7] Federal National Mortgage Association Charter Act, 12 U.S.C. §1716 Et seq. (the "Fannie Mae Charter Act")

In making Fannie Mae a private corporation, Congress attempted to strike a careful balance between private control and public regulation. The Secretary of HUD was given specific regulatory authority over Fannie Mae's actions, such as the issuance of common stock or obligations. The Secretary, however, also was given "general regulatory authority" over Fannie Mae.[8]

The relationship between the power and responsibility of the Fannie Mae Board of Directors for the policies of Fannie Mae and the "general regulatory authority" of the Secretary of HUD was not clearly defined.

The legislative history of the Fannie Mae Charter Act did not support the assertion that "general regulatory authority" meant a form of plenary regulatory authority. Testifying before the Senate Banking Committee in 1968, HUD Secretary Robert C. Weaver explained that the Fannie Mae Charter Act was not intended to give unbounded authority to the Secretary of HUD to control the operations of

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8/ Section 309(h) of Fannie Mae Charter Act, [12 U.S.C. §1723(a)(h)]

Fannie Mae. Weaver specifically disavowed the power to direct the Corporation to purchase particular categories of mortgages by "tak[ing] the position of saying 'invest here' or 'buy that'".[9] Rather, Secretary Weaver believed that his specifically enumerated power to control Fannie Mae's borrowings would give him "leverage" to negotiate with the Corporation about its purchases and investment.[10]

In April of 1978, the Secretary of Housing and Urban Development proposed regulations which would have involved the HUD Secretary in many of the day-to-day business decisions of Fannie Mae. Moreover, the proposed regulations sought to control many management and operational decisions. For example, the regulations provided that specified percentages of mortgage purchases must be from inner city areas. HUD's proposed regulations would have required Fannie Mae to devote 30 percent of its mortgage purchase commitments for central city mortgages. However, only 23.7 percent of the nation's owner-occupied housing stock was located in those areas and only 20 percent of housing sales transactions took place there. Reactions from home builders, realtors, mortgage bankers and the public in general was virtually unanimous in criticizing the broad scope of the regulations.

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[9] Housing and Urban Development Legislation of 1968: Hearings Before the Subcommittee on Housing and Urban Development of the Senate Committee on Banking and Currency, 90th Cong., 2d Sess. 60 (1968) (Testimony of the Honorable Robert C. Weaver, Secretary, Department of Housing and Urban Development)

[10] Testimony of Robert C. Weaver, 1968 Senate Hearings, at 60

On August 15, 1978, HUD issued its final regulations governing the operations of Fannie Mae.[11] The objectionable portions of the regulations were eliminated because of the negative public reaction and the threat of litigation by Fannie Mae. Nevertheless, the Secretary of HUD continued to assert that the "general regulatory authority" granted to the Secretary of HUD power to regulate operational decisions of the Corporation.

In short, Fannie Mae, modeled after the First and Second Banks of the United States, was created very much in the image of a private corporation, chartered by Congress, but owned, financed and controlled by its private shareholders. The final regulations promulgated by HUD did not purport to implement HUD's asserted "plenary" authority. The regulations carefully relied upon specific, enumerated powers in the Fannie Mae Charter Act to support each provision of the regulations. Whereas the proposed regulations relied upon the "general regulatory power" language of Section 309(h) of the Fannie Mae Charter Act,[12] the final regulations cited only specific, enumerated powers to support the final regulations.

Criticisms of S. 1929

Mr. Chairman, I next will turn to certain criticisms and perceived deficiencies in S. 1929. While I believe these criticisms of the legislation, in the main, are not well-founded, they merit careful consideration by this Committee. Recommendations for broad grants of regulatory authority to SBA, I believe, would seriously detract from the ability of COSBI to operate in the private sector. I will discuss each of the criticisms and recommendations for changes to S. 1929 as follows:

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[11] 43 Fed. Reg. 36200 - 36219

[12] 12 U.S.C. §1723a(h)

1. COSBI's federal backing removes market discipline that otherwise would limit unnecessary risk-taking and help promote long-term financial viability.

S. 1929 provides for a significant infusion of capital into COSBI by the SBIC industry. Section 353(a)(4)(A) provides that COSBI shall require each SBIC to purchase common stock in an amount equal to 1% of the private capital of each SBIC or nearly $25 million in total. Moreover, subsection (B) of that section provides that COSBI may require each SBIC to purchase additional common stock in an amount not in excess of 1% of any increases of the private capital of each SBIC. Further, the entire $1.5 billion in private capital in the SBIC industry is at risk. If COSBI takes undue risks or is not well-managed, the entire SBIC industry will be the financial loser. Clearly, this is not a "few million dollars" in capital that is cited as removing any market discipline from COSBI activities. If COSBI fails, the SBIC industry fails.

COSBI, therefore, will be subject to the strict discipline of the marketplace through shareholders who have a huge stake in ensuring that only sound business principles are followed by COSBI.

2. COSBI lacks effective regulation essential as a substitute for missing market discipline.

As noted above, the assertion of a lack of market discipline is incorrect. Moving from a faulty premise, a lack of "effective regulation" is cited and five specific improvements in the COSBI legislation are recommended in order for COSBI to be an "instrument of federal policy". "Control over COSBI and its safety and soundness should include (1) effective capital requirements, (2) government power to remove directors and management for cause, (3) a debt-to-asset limitation, (4) regulatory prior approval authority, and (5) general regulatory authority." The Fannie Mae Charter Act is recommended as providing a "good benchmark".

A. Capital Requirements

It is asserted that the capital requirements of Section 354(a) of S. 1929 and the debt-to-capital ratio in that section are inadequate if subordinated obligations issued under Section 354(b) are included in the computation of COSBI's capital and surplus. Yet, if the Fannie Mae experience is a good benchmark, it should be noted that Fannie Mae's subordinated obligations are included as capital for debt-to-capital purposes. Second, it is asserted that the COSBI debt-to-capital ratio does not restrict the volume of COSBI's issuance and guarantee of loan-backed securities under Section 356. It is contended that all such securities should be subject to the debt-to-capital ratio. Again, looking to the Fannie

Mae Charter Act, such a restriction does not apply in the case of Fannie Mae's guarantees of mortgage-backed securities under the Fannie Mae Charter Act.

B. Management Quality

It is recommended that S. 1929 be changed to permit removal by the President for cause of all directors and top corporate officers plus report language be added that justifiable cause for removal would exist when COSBI's net worth fell to some specified level. Net worth would be measured on a market-value accounting basis. Such a provision for the removal of all directors by the President is contained in the Fannie Mae Charter Act.

In 1978, the Secretary of HUD attempted to have the President remove two of the Fannie Mae directors for cause because of policy differences between the directors and the Secretary of HUD. The Office of Legal Counsel of the Department of Justice opined that the Secretary had stated inadequate reasons for the removal of the directors in question. The opinion further held in this regard that the President's authority to remove stockholder-elected directors is severely circumscribed.13/ In fact, such removal authority is more akin to that of the authority of a State Attorney General to seek to remove a director of a state-chartered corporation for cause.

13/ Opinion of the Office of Legal Counsel, the U.S. Department of Justice, concerning removal of Fannie Mae Directors (February 7, 1978)

C. Debt-to-Asset Limitations

The Fannie Mae Charter Act is cited as prohibiting it from issuing debt if such issuance would cause outstanding debt obligations to exceed its available assets. A similar restriction would be applied to COSBI on a market-value accounting basis. If such a restriction had been applied to Fannie Mae in 1980-1982, it would have been unable to issue debt to refund its outstanding maturing obligations. Clearly, it is unnecessary in the case of COSBI.

The Regulatory Relationship of the SBA and COSBI

The real issue is whether S. 1929 provides a regulatory system which will be sufficient to protect the interests of the government and to carry out the purposes of the Act. I believe S. 1929 more than adequately provides for the protection of the government's interest.

As an assurance of sufficient regulatory control over COSBI's activities, S. 1929 would codify all the major program regulations currently in place at the SBA and the Bill specifically contains the following safeguards with respect to the operation of SBICs and their funding of small business concerns: (1) the Bill adopts SBA's regulatory criteria for qualification of SBICs funding of small business concerns; (2) investments that are contrary to the purpose of the SBIC program are restricted; (3) SBA's regulations regarding definition of small business concerns is codified; (4) restrictions are imposed on the maximum investment in any small business concern by an SBIC; (5) requirements are established for conflict of interest regulation; and (6) SBICs are required to have private capital of $1 million (Section 358).

As is the case with Fannie Mae and Sallie Mae, all COSBI borrowings are subject to approval by the Secretary of Treasury ("Secretary"). To give the Secretary adequate information concerning COSBI's operations, audits conducted by independent auditors of COSBI are required to be provided to the Secretary. The legislation also ensures that the Congress will receive timely information concerning COSBI's operations. All reports prepared on COSBI must be furnished to the House and Senate Small Business Committees of Congress annually, and the Committees would have oversight over COSBI (Section 360). Thus, the legislation provides great leverage to the Secretary with the ability to prevent borrowings that are deemed improper, and provides Congress with current, and comprehensive information on COSBI so it can act in a timely manner if it becomes necessary to do so.

In addition, SBA will be authorized to examine the books and records of COSBI and will be provided annual reports of COSBI. GAO has been directed to prepare a report on COSBI and has been given full access to the books and records of COSBI. (Section 8) Furthermore, five members of COSBIs Board of Directors will be appointed by the President. The other ten members will be elected by the SBICs who are providing the equity for COSBI and whose interest in COSBI's success is tied intimately with the success of the SBIC industry (Section 352).

Section 360(h) does give SBA a seemingly broad authority to regulate COSBI by providing, "The Administration is authorized to make such rules and regulations as shall be necessary and proper to insure that the purposes of this title are accomplished." As was the case with the HUD-Fannie Mae "general regulatory" authority dispute, this general grant of authority does not accomplish the desired purpose. Rather, it becomes an invitation for the regulator to run the affairs of the regulated enterprise. This is incompatible with the goal of the government-sponsored corporation: to carry out its activities in pursuit of national interests in the private sector as a self-sustaining operation in the most efficient and effective way. Therefore, I recommend that this provision be deleted from S. 1929.

While the criticisms of S. 1929 have drawn the greatest analogies between COSBI and Fannie Mae (analogies which I believe to be faulty), it is also instructive to examine the record of Sallie Mae, perhaps the most successful financially and programmatically of all of the government-sponsored corporations. Sallie Mae is subject to considerably less government regulation and audit review than is provided in the COSBI legislation, it is not subject to regulatory review by any federal agency, nor is there a well-defined regulatory structure under which it must operate. Yet since the beginning of its operations in 1973, Sallie Mae has provided more than $22 billion in funds for educational purposes and has consistently maintained profitable operations. The lack of a more comprehensive regulatory structure has not affected the financial integrity, profitability or success of Sallie Mae's operation. Indeed, there is absolutely no indication that Sallie Mae has posed any financial risk to the Federal Government because of the lack of a more extensive system of regulatory oversight. Rather, the Sallie Mae Charter Act[14] is an excellent illustration that good management and not excessive federal regulation is the key to a successful government-sponsored corporation, able to perform its public purpose in the most efficient and effective way, while maintaining profitability.

Conclusion

In order to be able to accomplish its public purpose, COSBI must be self-sustaining. To be self-sustaining, it must be profitable and provide a return on the equity furnished to it by its shareholders, the SBICs. It is important to remember that in the first instance it is not only the capital furnished to COSBI by the SBICs but the entire capital of the SBIC industry that is at stake. This provides an overwhelming incentive for COSBI to be managed prudently and well. No amount of federal regulation or control can replace sound management which is responsive to the needs of the market and serves the public purpose for which it was created.

The bottom line is that virtually no amount of federal control or supervision will control the financial risk of the Federal Governmental in a government-sponsored corporation. Rather, the reverse unfortunately is more often the case. The financial plight of the savings and loan industry is attributable to a great extent to the "plenary" regulatory authority of the Federal Home Loan Bank Board which prevented thrifts from diversifying their asset mix during the 1970's. When depository deregulation finally came in 1980, the thrift industry was saddled with short-term liabilities and long term fixed-rate assets which it had been forced to invest in by government regulations.

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[14] 20 U.S.C. §1087-2

In summary, it is essential that COSBI be structured so that it will have the ability to be self-sustaining and profitable in order to perform its public function, subject to reasonable review and oversight by SBA and, most importantly, by the Congress.

EXHIBIT A

Government Sponsored Corportions - Summary of Legal Characteristics[a]

	Freddie Mac[b]	Fannie Mae[b]	Sallie Mae	Farmer Mac	COSBI[b]
Issuing authority under an Act of Congress	X	X	X	X	X
Exempt from SEC registration	X	X	X		X
Legal investment for National Banks, Federally Chartered S&Ls, and Federal Credit Unions	X	X	X	X	X
Issuable and payable through facilities of the Federal Reserve Bank	X	X	X	X	
Eligible collateral for Federal Reserve Bank advances and discounts	X	X	X	X	X
Public securities eligible to be purchased and held without limitation by National Banks	X	X	X	X	X
Supported by an authority to borrow from the U.S. Treasury Department		X	X	X	X
Obligations exempt from state and local income taxation			X		X
Issuance only upon approval by the U.S. Treasury Department		X	X		X
Backed by full faith and credit of the U.S.					
Eligible as collateral for Treasury tax and loan accounts	X	X	X	X	X
Eligible to open market purchases	X	X	X	X[c]	X
Eligible for National Bank repos without reserve requirements	X	X	X	X[c]	X
Eligible for private repos (outside the margin rules)	X	X	X	X[c]	X

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[a] This chart is a summary only.

[b] Both debt and guaranteed mortgage pass-through securities.

[c] Subject to rulings by the Federal Reserve Board and the Comptroller of the Currency.

EXHIBIT B

Organizational Comparison of FNMA, FHLMC, SLMA AND FAMC

Agency	Ownership	Management control	Federal oversight and regulations	How activities are financed	Federal guarantees	Audit Authority
FNMA	Stockholders	Board of Directors --5 appointed by the President of the U.S. --13 elected by stockholders.	Secretary of HUD through issuance of regulations and and program approval. Secretary of Treasury through approval of debt issuance. No authority over FNMA day-to-day management.	Cash flow from mortgage portfolio issuance of debentures and short-term discount notes, and fees from commitments and guarantees.	NONE. Charter Act authorizes $2.25 billion backstop authority at discretion of Secretary of Treasury.	Secretary of HUD has audit authority. By regulation, HUD may accept report of FNMA independent accounts. GAO specifically excluded from audit authority.
FHLMC	Member savings and loans of the Federal Home Loan Bank System	Board of Directors --3 members of the Federal Home Loan Bank Board --Advisory Committee selected by member banks.	Board of Directors, through approval of programs and budgets.	Sales of mortgage-backed securities and issuance of debt.	NONE. Can use assets of member institutions to provide additional capital if needed.	GAO has audit authority
SLMA	Stockholders	Board of Directors --7 appointed by the President of the U.S. --14 elected by stockholders.	Secretary of Treasury through approval of debt issuance.	Cash flow from loan portfolio and issuance of debt obligations. Borrowing from the Federal Financing Bank and private issuances.	Initial borrowings of $5 billion from FFB are backed by U.S. government. Backstop authorized to purchase $1 billion of obligations at discretion of Treasury.	Secretary of Education through independent accountants. GAO does not have audit authority.
FAMC	Stockholders	Board of Directors --5 appointed by the President of the U.S. --10 elected by stockholders	Farm Credit Administration through regulation.	Mortgage-backed securities.	NONE. Charter Act authorized. $1.5 billion backstop at discretion of Secretary of Treasury	FCA through independent accountants. GAO has audit authority.
COSBI	Stockholders	Board of Directors --5 appointed by the President of the U.S. --10 elected by stockholders	SBA has regulatory authority. Secretary of Treasury approves debt issuance	Issuance of debt and loan-backed securities	None. $500 million backstop at discretion of Secretary of Treasury, subject to appropriation.	SBA, independent accountants and the GAO have audit authority.

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April 15, 1988

The Honorable Dale Bumpers, Chairman
United States Senate
Committee on Small Business
SR-428A Russell Senate Office Building
Washington, DC 20510-6350

Dear Chairman Bumpers:

I am pleased to respond to the questions you raised on certain aspects of my testimony at the hearing on S. 1929 on March 31, 1988. Following are my responses to the questions you posed.

1. You recommended that we remove the general regulatory authority given to SBA from our bill, suggesting that the other oversight provisions are sufficient. How would you propose then that the SBIC's and Cosbi be supervised to insure the "financial soundness," as Mr. Stanton puts it, of the industry is preserved?

Answer

Removal of the provision in S. 1929 giving SBA general authority to adopt rules and regulations to insure that the purposes of the Act are accomplished should not adversely affect the "financial soundness" of the SBIC's and COSBI. The SBIC industry will have a huge financial stake in the financial soundness of COSBI. In addition to some $25 million in COSBI stock, the $1.5 billion of equity in the SBIC industry will be at risk with the future of COSBI. The success of COSBI, in turn, will rest, in great measure, upon its ability to adopt reasonable and prudent business practices which will insure that the SBIC's are financially sound. S. 1929 has a number of provisions which address this issue.

- The Bill adopts SBA's regulatory criteria for qualification of SBIC's funding of small business concerns.

- Investments that are contrary to the purpose of the SBIC program are restricted.
- Regulations defining qualified small business concerns is codified.
- Restrictions are imposed on the maximum investment in any small business concern by an SBIC.
- Requirements are established for conflict of interest regulations.
- SBIC's are required to have private capital of $1 million.
- All COSBI borrowings are subject to approval by the Secretary of Treasury.
- Audits will be conducted by independent auditors of COSBI and the reports of those audits will be furnished to the Secretary of Treasury.
- Congress will receive timely information concerning COSBI's operations through annual reports by COSBI which must be furnished to this Committee and the House Small Business Committee.
- The General Accounting Office will have full access to COSBI's books and records and will make a report to the Congress on COSBI's activities by January 31, 1993.
- SBA will be authorized to examine the books and records of COSBI and will be provided annual reports by COSBI.
- Five members of COSBI's Board of Directors will be appointed by the president.

2. Would you support regulatory language similar to that given to the Farm Credit Administration under the Farmer Mac Charter Act, which confines FCA's regulatory authority to "providing for the general supervision of the safe and sound performance of the powers, functions and duties vested in the Corporation (Farmer Mac), that would confine SBA's regulatory authority to providing for the protection of the interests of the small business community?

Answer

I do not believe such a provision would be effective because it would continue to give the SBA broad latitude in the interpretation and execution of regulatory powers.

Rather than "confine" the scope of SBA's regulations, the suggested language would continue to subject the full range of COSBI's and the SBIC industry's operations to SBA's regulations.

Certainly, protection of the interests of the small business community is an important consideration for the Committee. However, as I stated in response to the previous question, the Secretary of the Treasury and the SBA will have considerable authority under S. 1929 to assure that COSBI and the SBICs operate in the public interest and to the benefit of the small business community. The Committee will have ample opportunities in the future to examine the operations of SBICs and COSBI to determine if the purposes of S. 1929 are being accomplished.

3. Could SBA's regulatory authority be further limited to prohibit the agency from arbitrarily redirecting its policies toward regulation of Cosbi?

Answer

As I stated in my testimony, the basic question is "Who runs the company?" In order for COSBI to be successful, I believe it is essential that the Board of Directors, within the prescribed statutory framework and subject to all the reviews and audits provided, establish and implement the operating policies of the corporation. The interests of small business are amply protected by that framework and by the fact that the success of each SBIC is totally dependent upon the success of the small businesses in which it invests.

Granting SBA rulemaking authority, no matter how circumscribed, creates an inherent contradiction - it simply gives the Agency the power to set the agenda and determine the groundrules for the company's operations. My experience with HUD's general regulatory authority over Fannie Mae was that it was not effective and simply did not work. Congressional oversight was much more effective than an ambiguous and counterproductive regulatory grant in insuring that Fannie Mae accomplished its public purposes.

SBA can serve a useful role for the Congress by monitoring the activities of COSBI and the SBICs and reporting to the Congress on its findings. SBA's role in this process might be further enhanced by adding specific language to the statute giving SBA the authority to review, comment and report to the Congress on rules proposed by the corporation over the operations of SBICs.

I appreciate the opportunity to respond to your questions. Please advise me if there is any further assistance I can give to the Committee in its deliberations on S. 1929.

Sincerely,

James E. Murray

James E. Murray

JEM:ssj

Senator **Weicker**. I have no questions at this time. I think that it would behoove this Committee to move forward with the legislation, and I will so request that of the Chairman. Certainly if there are suggestions that you have which could improve upon the bill in its present form, those suggestions would be welcomed from you gentlemen, and others who have testified here this morning; otherwise, the Committee will now stand in adjournment. Thank you very much.

[Whereupon, at 11:00 a.m., the Committee adjourned.]

APPENDIX

Statement of the Chamber of Commerce of the United States

ON: A CORPORATION FOR SMALL BUSINESS INVESTMENT

TO: SENATE COMMITTEE ON SMALL BUSINESS

BY: NANCY R. FULCO

DATE: FEBRUARY 24, 1988

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest federation of business companies and associations and is the principal spokesman for the American business community. It represents nearly 180,000 businesses and organizations, such as local/state chambers of commerce and trade/professional associations.

More than 92 percent of the Chamber's members are small business firms with fewer than 100 employees, 59 percent with fewer than 10 employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business--manufacturing, retailing, services, construction, wholesaling, and finance--numbers more than 10,000 members. Yet no one group constitutes as much as 31 percent of the total membership. Further, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the 56 American Chambers of Commerce Abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross section of its members serving on committees, subcommittees and task forces. Currently, some 1,800 business people participate in this process.

STATEMENT
on
A CORPORATION FOR SMALL BUSINESS INVESTMENT
for submission to the
SENATE COMMITTEE ON SMALL BUSINESS
by
Nancy R. Fulco*
February 24, 1988

The U.S. Chamber of Commerce, on behalf of its 180,000 members, appreciates this opportunity to express its support for S. 1929, legislation transferring the Small Business Investment Company (SBIC) and the Minority Enterprise Small Business Investment Company (MESBIC) programs of the Small Business Administration (SBA) to a new Corporation for Small Business Investment (COSBI). The Chamber supports S. 1929 because it maintains a historically successful program; reduces the federal deficit; and allows a federal program to become more reliant on the private sector.

Since 1958, the SBIC program has served to narrow the gap between the small business community's need for long-term growth capital and accessible capital. This gap exists for two reasons: banks and other lending institutions perceive investments in young small businesses as too risky; and private venture-capital funds invest selectively in only a few industry segments in which a high potential for growth exists.

Distinctions Between SBICs, MESBICs, and Venture Capital

Statistics show the valuable contribution that SBICs and MESBICs have made. As of March of 1987, SBICs had invested $7 billion in approximately 85,000 small businesses. In 1986 alone, SBICs and MESBICs financed almost three times the number of small businesses as were financed by the private venture-capital industry. SBICs and MESBICs, with a capital base of $1.6 billion, financed approximately 3,271 companies, while private venture-capital firms, with a capital base of $17.8 billion, financed approximately 1,180. SBICs and MESBICs accomplish this by limiting the size of investments in a particular small business. In 1986, the average size of a SBIC financing was approximately $250,000 as compared with nearly $2 million for private venture-capital firms. Finally, SBICs are much more likely than the private venture-capital industry to finance companies less than three years old. In 1986, SBICs and MESBICs invested approximately 64 percent of their capital base in companies less than three years old, while private venture-capital invested only 39 percent. SBICs also invest in start-up companies twice as much. SBICs used 33 percent of their capital base to finance start-up companies in 1986, as compared with only 15 percent invested by private venture firms.

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*Associate Manager, Legislation, Small Business Center

Challenges Facing the SBIC Industry

Although the success of SBICs and MESBICs is apparent, the program is not without problems. The current process under which the program is administered no longer meets existing needs. SBICs, by definition, are long-term investors and, therefore, need a dependable source of funds as well as a climate conducive to effective planning and investing. The funding process of SBICs and MESBICs creates great concern because of the uncertainties of annual Congressional appropriations and the limited allocations of scarce monies. Constantly changing regulatory policies intensify the atmosphere of financial uncertainty. These problems are unnecessary impediments to expanded SBIC and MESBIC growth.

For these reasons, the SBICs have proposed creating COSBI. They believe that COSBI would allow them to develop a constant and stable source of funds to operate efficiently and that COSBI would continue to provide valuable financing for small businesses of the SBIC industry.

The Chamber supports S. 1929 for the following reasons:

- SBICs will provide an initial investment of $20 million to start COSBI. This money will be provided from their private capital.
- COSBI will be granted federal agency status. This should make its securities more acceptable to private investors.

- COSBI will sell debentures in the capital markets to raise a constant flow of cash for the SBICs. This will provide two advantages that they currently do not enjoy. First, they no longer will rely on government funding. Second, they will be freed of the vagaries of the Congressional budget process. These advantages will allow them to operate in a more businesslike and effective fashion.
- COSBI will have a U.S. Treasury "backstop" of $500 million. This, again, has several advantages. First, implementation of the backstop authority requires Congressional action and a request from the Secretary of the Treasury and will consequently have no impact on the federal budget until it is requested. Second, the existence of the backstop will help to ensure that securities of COSBI are attractive to investors.
- COSBI will purchase, with cash and at par, the current SBIC debt in the amount of $720 million held by the Federal Financing Bank (FFB). Financial analysts predict this large, immediate asset base will allow COSBI to be accepted positively by the marketplace.
- Many of SBA's current SBIC regulations — including prohibitions on self-dealing, relending/refinancing, and land speculation — will be codified into law. The Chamber supports this codification. These regulations were intended originally to protect taxpayers' dollars from misuse. With the possibility, albeit slight, of Congressional appropriations to COSBI via the backstop, these regulations need to remain.
- One-third of COSBI's directors will be appointed by the President. The remaining 10 directors will be elected by the SBICs through cumulative stock voting. Furthermore, the provisions for government oversight of COSBI's financial performance and regulatory performance will protect the government's interest in COSBI and will provide an early warning signal as to the need for any federal financial involvement via the backstop. Because of the unique nature of COSBI relative to the range of small business financing programs administered by

the federal government, the Chamber applauds and supports the inclusion of a provision for Executive Branch authority to issue regulations ensuring that the purposes of S. 1929 are carried out.

The benefits of COSBI are substantial. Small business will benefit the most with increased access to long-term venture capital. As a result, there will be even more new jobs created in a variety of industries, more new tax revenues generated, and, over time, a reduction in the federal deficit. Additionally, the increased investments through COSBI will encourage new product innovations and technologies.

The Chamber supports a reduction in the federal deficit, increased reliance on the private sector, and the maintenance of a growing economy through small business expansion. S. 1929 will accomplish these objectives.

Thank you for the opportunity to submit the Chamber's views on this important legislation.

THE SECRETARY OF THE TREASURY
WASHINGTON

FEB 2 5 RECD

February 24, 1988

Dear Mr. Chairman:

This letter expresses the views of the Department of the Treasury on S. 1929, the "Corporation for Small Business Investment Charter Act."

Section 4 of S. 1929 would amend title III of the Small Business Investment Act of 1958 by adding a new part "B." Section 352 of part B would create a Government-sponsored private Corporation for Small Business Investment ("COSBI") that would serve as a secondary market and warehousing facility for loans to and investments in Small Business Investment Companies ("SBIC"). Section 359 of part B would establish a special small business investment companies ("SSBIC") trust. The SSBIC trust and COSBI would operate a special SBIC subsidy program similar to the current Minority Enterprise Small Business Investment Company ("MESBIC") program.

The Department of the Treasury strongly opposes S. 1929. As Secretary Baker indicated in his October 1, 1986, letter to Senator Weicker (copy enclosed) concerning a similar COSBI proposal, the Department generally is opposed to the creation of a new Government-sponsored enterprise. While S. 1929 has been described as a privatization measure, COSBI would have extensive financial ties to the Federal Government and would enjoy other special benefits. COSBI would not be a truly private enterprise, and its receipts and outlays would be included in the budget totals for the indefinite future.

The proposed "private" COSBI would assume the current role of the Small Business Administration ("SBA") in financing SBICs, and would do so with strong Federal financial backing as well as other benefits typically afforded to Federal agencies. At the same time, however, COSBI would not be subject to the oversight and control of its spending and other activities in the same manner as are SBA and other Federal agencies. Thus, COSBI may consider itself free to dissipate its resources in the belief that Congress, as in the recent Farm Credit System example, may take supportive action.

To finance its activities, COSBI would be authorized to issue voting common stock that SBICs would be required to purchase; non-voting common stock; preferred stock; warrants to Treasury that would be convertible into common stock; senior debt obligations to the public and the Treasury; subordinated obligations to the public; and participations or pooled interests in its assets, including assets guaranteed by SBA. Although the authority to borrow from the Treasury has been described as a backstop for COSBI's financial obligations, the bill contains no restriction on the use of the borrowing authority. Thus, COSBI could borrow from Treasury for any of its authorized purposes, including salaries and administrative expenses.

We are particularly concerned that only the issuance of debt obligations would be subject to the approval of the Secretary of the Treasury. All other forms of COSBI's direct and contingent liabilities, however, would not be subject to Treasury approval. Thus, by simply changing the designation of a financial instrument from "debt" to "participation," the Corporation could escape the Treasury approval requirement, with potentially disruptive consequences for the market for Federal and federally-related securities, and the debt-to-equity limit. We also note that the aggregate amount of debt obligations issued under section 354 would be limited to 15 times COSBI's capital, unless a higher ratio is established by the SBA. Even if applied to all direct and contingent liabilities, this debt-equity ratio is extremely high, particularly in light of the almost 33 percent default ratio under the existing SBIC program. This will increase the likelihood of a future congressional rescue.

COSBI's initial asset base would be backed by the full faith and credit of the United States. No later than October 1, 1988, the Secretary of the Treasury would be required to sell to COSBI the entire Federal Financing Bank ("FFB") holdings of SBA-guaranteed SBIC debentures, which would continue to be guaranteed by SBA after sale. The final purchase price of the debentures could not be less than $720 million, irrespective of the value of the FFB holdings on the date of sale. Not only would this result in windfall gains or losses to the FFB and COSBI, but the FFB would receive only about half of the proceeds of the sale in cash. Immediately upon sale, $150 million of the proceeds would be transferred to the SSBIC trust outside of the normal budget/appropriations process. An additional $200 million would be in the form of COSBI preferred stock.

The SSBIC trust, which would be under the control of four industry representatives and one Presidential appointee, would receive SBA's existing portfolio of MESBIC preferred stock and debentures without compensation to SBA. While the value of this giveaway cannot be determined in advance, the subsidy undoubtedly will be measured in billions of dollars when a final accounting is made following the redemption of all preferred stock and debentures.

The trust would be used to cover losses on MESBIC or SSBIC debentures purchased or guaranteed by COSBI, to buy down interest rates on SSBIC debentures, and to purchase SSBIC preferred securities. Since COSBI's losses on its purchases or guarantees would be covered by the trust, there would be little incentive for COSBI to scrutinize the credit worthiness of SSBIC issuers. Moreover, although the trust corpus would revert to the Treasury at the end of the trust's 50-year life, there is little reason to believe any amounts would be returned to the Treasury because the trust would be controlled by industry representatives.

Under existing budget scoring rules applicable to government-sponsored enterprises, COSBI's receipts and outlays would be included in the Federal budget as long as the Government holds an equity interest in COSBI. The absence of Administration and congressional controls over the spending activities of COSBI will only exacerbate the problems of budget control and deficit reduction.

In view of the foregoing, the Department would recommend to the President that he veto S. 1929 or any similar legislative proposals.

The Office of Management and Budget has advised that there is no objection to the submission of this report to your Committee and that the enactment of S. 1929 would not be in accord with the program of the President.

Sincerely,

George D. Gould
Acting Secretary

The Honorable Dale Bumpers
Chairman
Committee on Small Business
United States Senate
Washington, D.C. 20510

Enclosure

THE SECRETARY OF THE TREASURY
WASHINGTON

October 1, 1986

Dear ~~Senator Weicker~~ Lowell:

I am writing to express my strong concern regarding the provisions approved by the conferees on the Reconciliation Bill to establish a Corporation for Small Business Investment.

Although the proposal has been advanced as a "privatization" measure, the proposed corporation would not be truly private due to the extensive financial ties to the Federal Government and other benefits which would be provided to the corporation. These ties and benefits include the authority of the Corporation to borrow from the Treasury to backstop its financial obligations, the ability to purchase SBIC debentures held by the Federal Financing Bank at prices unrelated to market prices, exemption from State and local taxation, and exemption from SEC regulation.

I strongly urge that the COSBI provisions be deleted from the bill.

In addition to my general opposition to the creation of a new Government sponsored enterprise, I am deeply concerned by what the bill would not do. In particular, I am very disturbed about the absence of any effective oversight or control over the Government's exposure to loss from the operations of either COSBI or the SBICs. There should be some clear regulatory oversight over COSBI, as HUD has over FNMA. This COSBI regulator should have reasonable oversight and authority over the SBICs. The Treasury should have approval authority over the issuance of COSBI debt, not just its terms and rates. There should be a reasonable debt to equity ratio limit on COSBI's borrowings reflecting the credit quality of its assets, which could easily be argued to be as low as 3-to-1 given the default record on SBIC debentures to date.

Sincerely,

Jim

James A. Baker, III

The Honorable
Lowell P. Weicker, Jr.
United States Senate
Washington, D.C. 20510

Small
Business
Legislative
Council®

March 7, 1988

The Honorable Dale Bumpers
Chairman
Senate Small Business Committee
SR-428A Russell Senate Office Building
Washington, DC 20510

Dear Mr. Chairman:

On behalf of the Small Business Legislative Council (SBLC), I wish to express our support for passage of S.1929, legislation to create a Corporation for Small Business Investment (COSBI). The Small Business Legislative Council (SBLC) is a permanent, independent coalition of over ninety trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of over four million small businesses in manufacturing, retailing, distribution, professional and technical services, construction, transportation and agriculture. A list of our members is attached.

Innovation and entrepreneurship are words that have become virtually synonymous with small business, and certainly synonymous with the unique segment of the venture capital community known as the small business investment company (SBIC) and the minority enterprise small business investment company (MESBIC). It should come as no surprise to learn that they have lived up to these credentials in developing a solution to their funding problem, that not only solves the problem, but ensures an even brighter future for those small businesses in need of venture capital. It is just this kind of initiative that allows small business to keep our economy strong and a cut above the rest of the world.

There is no need for us to review in this statement the specifics of the COSBI proposal. Your Committee has done yeomanlike work in refining this proposal and it is an example of fine legislative craftsmanship. We do want, however, to bring us all back to the point of this program. With a proposal as sophisticated and complex as COSBI it is easy for us to become mired in the technical details or to focus on the immediate players, the venture capital companies, rather than the ultimate beneficiaries--small business and entrepreneurs.

1025 Vermont Avenue, NW/Suite 1201/Washington, D.C. 20005/(202) 639-8500

We hope we speak for the beneficiaries, past and future, as well as those many small business owners who encourage other entrepreneurs because they know first hand the more diverse our economy, populated by small business, the better off we all are. The SBIC and MESBIC programs work. We often get caught up in our own rhetoric about jobs created, but the truth is we ask these venture capital companies to go where no one else will venture. We want SBICs and MESBICs to take the risks, to seek out the opportunities that do require a roll of the dice. The record of these programs do, in fact, show that they can pick the winners, but we do not need the statistics to tell us that these programs are of value.

We believe the proposal is a careful balance between the twin towers of concern for small business. On one hand, we are well aware that government does have a role in priming the small business job creation machine. The start up scenario is one of the few instances where government can legitimately play a role. In a slightly different context, former Senator Long once said about an incentive in the tax code, "I'm not adverse to using a little sugar to get the horse in the barn." At the same time, to the extent we can move a government program to greater reliance on the private sector, we would encourage it. COSBI accomplishes both of these goals.

On behalf of SBLC, we encourage the Committee on Small Business and the Congress to move quickly to create the Corporation for Small Business Investment.

Sincerely,

John S. Satagaj
President

JSS/0435
Enclosure
cc: Lowell P. Weicker, Jr.,
Ranking Minority Member

Small
Business
Legislative
Council®

Members of the Small Business Legislative Council

Alliance of Independent Store Owners and Professionals
American Association of Nurserymen
American Consulting Engineers Council
American Council of Independent Laboratories
American Dental Trade Association
American Electronics Association
American Floorcovering Association
American Machine Tool Distributors Association
American Society of Travel Agents, Inc.
American Sod Producers Association
American Subcontractors Association
American Textile Machinery Association
American Trucking Associations, Inc.
American Warehousemen's Association
Architectural Precast Association
Associated Builders & Contractors
Associated Landscape Contractors of America
Association of Physical Fitness Centers
Association of Small Business Development Centers
Association of the Wall and Ceiling Industries-International
Automotive Service Association
Automotive Warehouse Distributors Association
Building Service Contractors Association International
Business Advertising Council
Christian Booksellers Association
Electronic Representatives Association
Florists' Transworld Delivery Association
Helicopter Association International
Hobby Industries of America
Independent Bakers Association
Independent Bankers Association of America
Independent Insurance Agents of America, Inc.
Independent Medical Distributors Association
Independent Sewing Machine Dealers Association
International Association of Refrigerated Warehouses
International Bottled Water Association
International Communications Industries Association
International Fence Industry Association
International Franchise Association
International Reciprocal Trade Association
Latin American Manufacturers Association
Machinery Dealers National Association
Manufacturers Agents National Association
Mechanical Contractors Association of America, Inc.
Menswear Retailers of America
National Association for the Self-Employed
National Association of Aircraft and Communication Suppliers
National Association of Brick Distributors
National Association of Catalog Showroom Merchandisers
National Association of Chemical Distributors
National Association of Development Companies
National Association of Home Builders
National Association of Investment Companies
National Association of Manufacturing Opticians
National Association of Personnel Consultants
National Association of Plumbing-Heating-Cooling Contractors
National Association of Realtors
National Association of Retail Druggists
National Association of Small Business Investment Companies
National Association of the Remodeling Industry
National Association of Truck Stop Operators
National Association of Women Business Owners
National Candy Wholesalers Association
National Chimney Sweep Guild
National Coffee Service Association
National Council for Industrial Innovation
National Electrical Contractors Association
National Fastener Distributors Association
National Grocers Association
National Independent Dairy-Foods Association
National Machine Tool Builders' Association
National Motorcycle Retailers Association
National Moving and Storage Association
National Office Products Association
National Parking Association
National Precast Concrete Association
National Shoe Retailers Association
National Society of Public Accountants
National Tire Dealers & Retreaders Association
National Tooling and Machining Association
National Tour Association
National Venture Capital Association
Opticians Association of America
Petroleum Marketers Association of America
Printing Industries of America, Inc.
Retail Bakers of America
Small Business Council of America, Inc.
Smaller Manufacturers Council
Society of American Florists
Specialty Advertising Association International
United Bus Owners of America

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NSBU
NATIONAL SMALL BUSINESS UNITED
"Serving America's small businesses since 1937"

Mr. Chairman, members of the Committee:

National Small Business United (NSBU) submits this statement in support of S. 1929, the bill co-authored by Senators Bumpers and Weicker for the purpose of creating a Corporation for Small Business Investment (COSBI) to serve as a Capital Bank and licensing and regulatory authority for the small business investment industry.

NSBU was established in 1986 as a result of a merger between the National Small Business Association (a general small business membership association founded 50 years ago, and headquartered in Washington, D.C.) and Small Business United, a federation of a dozen regional, state, and metropolitan independent small business associations across the country. Our combined organization represents approximately 50,000 small business enterprises nationwide.

Our association represents the users of venture capital, the new and growing firms that are attempting to obtain capital on reasonable terms for expansion. Although we have not surveyed our membership on the use of the Small Business Investment Company (SBIC) program, many of the leaders and members of our organization have, over the years, personally observed examples of how SBIC lending and investment benefits their communities and

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the national economy as well as the small firms that are recipients of these funds.

ROLE OF THE SBIC PROGRAM

From our experience, and the record of the public hearings on the SBIC program so far, our opinion of the SBIC program is in agreement with the Joint Economic Committee of Congress, which concluded in 1984 that "SBICs are satisfying a capital market need that (would not be met) if SBICs did not exist." ("Venture Capital and Innovation", Joint Economic Committee, 1984).

This conclusion is supported by statistics on the SBIC program as published by the Small Business Administration (in the annual SBIC digests) and the comparable numbers for non-SBIC Venture Capital activity (in the annual reports of the National Venture Capital Association, published by Venture Economics, Wellesley, Mass.). These figures show that, in 1986, a year for which complete and comparable information is available, average per company investments were as follows:

Average Investments of Various types of
Venture Capital Providers
(1986)

- Private, non-SBIC providers -- about $1.9 million per company

- Regular SBICs -- $269,000 per company, and

- Minority Enterprises SBICs -- $101,000 per company

Further, while private non-SBIC providers placed about 39% of their funds in enterprises less than 3 years old in 1986, the comparable figure for SBICs is 64.3% and for Minority Enterprises SBICs 67%. In 1986, SBICs and MESBICs financed 3,208 companies on a private capital base of approximately $1.46 billion. Private non-SBIC venture capital providers financed 1,180 companies on a capital base of about twelve times as large (approximately $17.8 billion). It is thus apparent that the SBIC/MESBIC program services smaller and earlier stage companies, and is a vital link in capital formation process in this country.

PROGRAM ACCOMPLISHMENTS

Since the original legislation in 1958, SBICs have provided a combination of financing and management assistance to more than 85,000 small businesses in the amount of more than $7 billion in substantial amounts in every state. According to the testimony of the National Association of Investment Companies (House Small Business Committee, Feb. 25, 1988) the more focused Minority Enterprise SBICs, in the 1978-87 decade, invested $750 million in 8,468 enterprises that provided jobs to 118,524 employees and generated sales of $7.2 billion.

We regard the SBIC program as an excellent investment for the United States of America. As a consequence of this program, new and small enterprises are being established all over this country and provided with opportunities to grow and develop improved products and services by virtue of the unique combination of early state financings and management assistance that Congress has wisely provided in the Small Business Investment act and its amendments over the past 30 years.

PROGRAM PROBLEMS

However, the program's achievements are only part of the story, as we see it.

The splendid success of this program has been dimmed for the past few years and its future potential has been clouded by the treatment accorded to SBICs by the Executive Branch of the Federal Government.

To gain a perspective on this treatment, let us compare the performance of the SBIC program with private non-SBIC venture capital activity.

In terms of resources, the total pool of venture capital in the U.S. has grown ten-fold since 1978 (from approximately $2 1/2 billion to about $24 billion). Over the same decade, the private capital of SBICs and Minority Enterprise SBICs grew from $408.9 million to $1,290, or three-fold ((315%). The growth of private capital in the MESBIC industry has fallen from 27% at the beginning of the 1980's to less than 1% in 1987. Thus, the SBIC program has not been as effective in attracting capital as the general field of venture capital investment.

In terms of disbursements actually made to finance small firms, non-SBIC venture capital disbursements grew 52% between 1978 and 1986, (from $550 million to $2.9 billion) with a higher, but yet undetermined, figure for 1987. Over the 1978-87 period, combined SBICs and Minority Enterprise SBICs disbursements grew from $238.8 in 1978 to $624.5 in 1987, a growth of 162%. The SBIC figure lags far behind the growth rate of venture capital disbursements in general and the private non-governmental venture capital entities in particular.

We are particularly concerned that during the last three years, SBIC and MESBIC disbursement have grown at an average rate of only 4.6%, while the U.S. economy has been in the midst of a sustained economic advance.

REPORT CARD ON THE SBIC PROGRAM

Our organization just does not regard these results of the SBIC program over the past decade as satisfactory, either to the small business community, or in terms of the need to make the American economy more competitive at home and in world markets. The evidence suggests to us that there is a substantial potential in the SBIC program that is not being utilized, and that the Executive Branch of the Federal Government is not willing to provide the financial, regulatory or moral support that is called for. We further believe that the underutilization of these programs is hurting the members of our association, and that it also translates into missed opportunities for the creation of new enterprises, the development of new technologies, production of improved goods and better services, not to mention the higher level of domestic employment and of federal, state and local revenues that the studies of this process such as the General Accounting Office (GAO/AFMD 82-36, August 12, 1982) and others unanimously and uniformly attest result from venture capital investment.

The impact of the recent stewardship of this program is also reflected in an actual decline in the number of SBICs -- from a peak of 391 at the end of 1984 to 307 at the end of 1987 -- a reduction of 21 1/2% in the past three years.

In the opinion of NSBU, a further heavy cost of the recent direction of the program is being paid in the erosion of the American dream, which has an especially poignant impact in the area of minority enterprise. The number of Minority Enterprise SBICs peaked in 1985 at 146 and dropped to 128 at the end of 1987, a decline of 12%. According to the House testimony cited above, "(There has not been) a single year since 1981 when we have not been fighting for the continuation of our (MESBIC) program (page 4). There is further pressure on the program this year because the Administration's budget submission for Fiscal Year 1989 proposed "the elimination of all special incentives for the industry." (House Testimony, Feb. 25/88, page 2; see also "Minority Venture Capital Program Loses Federal Funding in Reagan's '89 Budget, "Wall Street Journal, March 8/88, page 53).

The record establishes that there are problems in the current administration of these programs.

PROPOSED SOLUTIONS

In the past, government-sponsored enterprises have been cost-effective solutions to imperfections in American financial markets.

For example, the Federal National Mortgage Association (Fannie Mae) has resulted in a national secondary market for residential mortgages. Similarly, the Student Loan Marketing Association (Sallie Mae) has accomplished the same results for student loans. These organizations and others have provided an institutional and professional framework for dealing with financial intermediation.

The SBIC program, during its thirty-year history, has lacked a central financial funding mechanism that raises funds directly from private capital markets. We believe that establishment of such a mechanism is overdue. The maturity of the industry in initiating the COSBI proposal is, we feel, a good indication that the SBIC program is at the threshold of graduating to a status comparable to other government-sponsored enterprises.

As we understand the structure of COSBI, it would be based on a contribution of private capital which would be at risk in the private sector management of COSBI under a public-private board of directors. Federal sponsorship would be in the form of a backstop. We believe such a backstop has not been utilized by such government-sponsored enterprises as Fannie Mae or Sallie Mae. In farm credit, there have been liabilities from government involvement, and we feel the Committee should address the relevant issues in this area.

SUMMARY

In our opinion, COSBI offers a promise of a long-term institutional environment for obtaining funds for the SBIC industry and for the development of career-oriented personnel and a rational regulatory structure for administering that industry.

We believe that COSBI offers promise of a vehicle for the prudent management of the risk of venture capital investing by both the private sector and the Federal Government.

The Committee should utilize the decades of experience with existing government-sponsored enterprises to create legislation which will adequately protect Federal Government while placing the small business investment industry in an environment where it can realize its true potential for small business and for Nation.

We would be glad to work with the Committee in answering questions, furnishing information, or providing further views on the development of this legislation.

NASBIC
NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES
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NEW YORK, NY

March 23, 1988

The Honorable Dale Bumpers, Chairman
Committee on Small Business
United States Senate
Washington, DC 20510-6350

Dear Senator Bumpers:

This is in response to your letter of March 3, 1988, in which you ask for our views on the AICPA's comments on certain auditing provisions of S. 1929, the COSBI Charter Act, contained in their letter of February 23, 1988.

Two of their suggested changes are purely technical in nature, and we endorse those changes as perfecting language that will impove the bill. Those specific changes are as follows:

1. Amend the initial sentence in Section 360(c) by substituting the words "financial statements" for the word "accounts." This revision will bring the bill into technical conformity with the properly described function of independent auditors, i.e. to examine and opine on financial statements, rather than accounts, of an entity.

2. Amend the second sentence in Section 360(d) by substituting (at lines 6 and 7) the words "statement of cash flows" for the words "statement of sources and applications of funds." This revision will bring the bill into technical conformity with the recently issued FASB Statement of Financial Accounting Standards No. 95 (November, 1987).

The other suggestion by AICPA is, as you noted in your cover letter, a substantive revision; and it does give us serious concern. Section 358(j)(2) of S. 1929 currently provides that a compliance audit of each participating SBIC shall be performed "at least every two years." The AICPA suggests that the provisions dealing with compliance audits should conform to the GAO's "Yellow Book" for government organizations, meaning that such audits should be performed every year.

We respectfully disagree with AICPA's suggestion on this point, and strongly urge the Committee to retain the existing version of Section 358(j)(2) now in the bill.

We disagree with the AICPA suggestion for several reasons. The minimum two-year compliance audit frequency was carefully designed to recognize the realities of the SBIC program. Based on 30 years of experience, we know that a significant number of SBICs operate year-in and year-out on a squeaky clean basis with no violations. Many of these SBICs do not use leverage, and they are also audited by other state and federal regulatory agencies. Forcing these SBICs to undergo an expensive and time-consuming compliance audit simply to conform to the "Yellow Book" is an unnecessary and counterproductive exercise.

We would point out that the SBA Inspector General and the SBA's Investment Division agree with our position on this issue. As you know, for the past several years they have proposed an amendment to the current law which would provide for a minimum two year compliance audit frequency. The House Small Business Committee has included this amendment in their FY 1989 SBA Authorization Bill, and we understand your committee will also be considering this amendment as part of your SBA authorization proceedings. Under the circumstances, a position of forced consistency with the so-called government "Yellow Book" apparently does not make sense to the SBA Inspector General; nor does it to us.

We have supported SBA's position on this issue as a matter of good business practice. Those same sound business principles will apply to the system of SBIC compliance audits under COSBI. Providing for a compliance audit at least every two years does not preclude audits on a more frequent basis. We fully expect that audits each year will be the norm, and audits as frequently as quarterly might be expected in those cases where there are serious concerns regarding regulatory compliance.

/

At the same time, the two year provision will give COSBI (like SBA) the latitude to forgo a mandatory annual audit where the track record of an SBIC clearly indicates it is not required. This common-sense approach to audits will reduce COSBI's overhead costs and staffing requirements, making it a more streamlined and efficient operation to serve SBICs and small business.

We would strongly urge that you retain the existing version of Section 358(j)(2) in S. 1929.

I have been authorized to advise you that the National Association of Investment Companies (NAIC) concurs with this position.

Thank you for the opportunity to submit our views.

Sincerely,

Peter F. McNeish
President

cc: JoAnn Price, NAIC
David Jones, NASBIC
Bob Philip, Arthur Andersen

THE CITY OF NEW YORK
OFFICE OF THE MAYOR

SALLY HERNANDEZ-PIÑERO
COMMISSIONER

OFFICE OF FINANCIAL SERVICES
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STATEMENT

SENATE COMMITTEE ON SMALL BUSINESS
HEARING ON THE CORPORATION FOR SMALL BUSINESS INVESTMENT BILL
March 31, 1988

Sally Hernandez-Piñero
Commissioner, Office of Financial Services
New York City, New York

April 14, 1988

Mr. Chairman, thank you for the opportunity to submit this statement about the proposed Corporation for Small Business Investment Charter Act (S.1929). I am Sally Hernandez-Piñero, Commissioner of the Office of Financial Services of New York City. In this capacity, I am involved in the design and implementation of a variety of financial incentive programs that promote economic development in New York City.

I fully support S.1929. This legislation would help provide capital to small and growing businesses at no cost to the federal government. Small businesses are the backbone of our economy. Ninety-eight percent of all businesses in New York State[1] and New York City[2] have less than 100 employees. These businesses have been the fastest growing sector of our economy, creating the vast majority of job opportunities throughout the United States. These companies are more likely to employ women and minorities than larger companies,[3] and are very responsive to changing economic conditions.

Small businesses are also good financial risks. Financial Services Corporation of New York City (FSC), a local development corporation which works closely with the City in structuring assistance to small and medium-sized businesses, has provided financial assistance to more than 650 projects. Over 90% of the companies FSC assisted have fewer than 200 employees and 75% employ less than 100 workers. These projects have enabled New York City to retain and create more than 65,000 jobs. Over 60% of these jobs are held by minorities. FSC reports that it was able to accomplish these feats with a loss rate on certain loan programs of less than one percent.

One of the major problems plaguing small businesses is the inability to secure sufficient funds for daily operations or potential expansion.[4] Traditional private sector sources are not fulfilling this need. The vast majority of loans made by commercial banks are over $1 million. Only an estimated 16.5% of the short term loans made by commercial banks (less than 1 year), and 23.3% of long term loans (greater than 1 year), are for amount less than one million dollars.[5]

States' and municipalities' ability to assist many qualified small businesses have been severely limited. Budget cuts in major federal programs (i.e., UDAG, CDBG, EDA and SBA), new federal restrictions on existing resources, and federal tax reform have also hurt these efforts. For example, the Tax Reform Act of 1986 severely restricted the use of industrial development bond financing to promote business expansion and job creation in distressed areas throughout the country.

A government-sponsored private corporation to serve the capital needs of small businesses is an excellent idea. It would help channel capital to productive uses--to fuel the generation of new economic activity and jobs. Small businesses have unique characteristics and their financial needs differ from those of large enterprises. The private sector alone cannot fully service small businesses' financial needs. Small Business Investment Corporations (SBICs) attempt to fill this gap by providing expert financial advice and financial assistance to small firms. There are currently 59 SBICs and 44 MESBICs (Minority Enterprise Small Business Investment Corporations) in New York State. From 1980 through 1986, SBICs financed 3,311 projects for a $370,720,107 investment in New York State.

The proposed legislation enables COSBI, the Corporation for Small Business Investment, to use creative financing tools such as participations and pooled offerings to gain access to private capital that is not now accessible to SBICs. This will provide increased funds to small businesses without placing a financial burden on the federal government. By capitalizing on economies of scale and diversification of risk, COSBI will be able to raise capital at more attractive rates than these small businesses would be able to access on their own. This will provide the same type of secondary market financing opportunities that are available to the residential mortgage market.

I also fully support the opportunities that will be generated by a bill introduced by Senator D'Amato (S.941) to allow State and local public funds to be included in the "paid in capital and surplus" requirement. This legislation will encourage the formation of new small business investment companies (SBICs). By participating in SBICs, local and State governments would be able to take a more active role in supporting small businesses. Senator D'Amato's bill would support the building of new public/private partnerships to serve this vital part of our economy. This bill would enhance the proposed COSBI legislation by increasing the effectiveness of SBICs in obtaining and allocating resources based on public and private objectives. Public funds should and would be used to leverage a significant private investment to promote economic development.

We urge the committee to adopt S.941 as a part of the COSBI legislation. We applaud the creative concepts incorporated in these bills, and urge you to support their passage. Thank you.

NOTES

1. 1986 Annual Report, Committee on Small Business, New York State Assembly, P.1

2. New York State Department of Labor, March, 1987

3. Small Business Financing Needs in New York State, New York State Assembly Committee on Small Business, 1986, P.1

4. Id.

5. Extrapolated from Survey of 340 Commercial Banks, 1986, Federal Reserve